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SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

October Term, 1971

B. FORMAN COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No.: .....

McCURDY & COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No.: .....

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners ask that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit.

Opinions Below

The opinion of the Court of Appeals (Appendix, pp. A40ff.) is not yet officially reported but is unofficially

reported at 29 AFTR2d ¶ 72-348 and 72-1 USTC ¶ 9182. The opinion of the Tax Court (Appendix, pp. A17ff.; R. *25a-48a) is reported officially at 54 T. C. 913 (1970).

Jurisdiction

The decision of the Court of Appeals was rendered on January 10, 1972, and the judgment was entered on the same day (Appendix, pp. A73ff.) The jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

Questions Presented for Review

1) Whether the authority of the Commissioner of Internal Revenue under § 482 of the Internal Revenue Code to "distribute, apportion or allocate" items of income among related taxpayers permits him to increase the taxable income of the maker of an interest-free loan by a hypothetical arms-length interest charge without showing that the proceeds of the loan generated net income for the borrower.

2) Whether a corporation and one of its shareholders are "owned or controlled directly or indirectly by the same interests" for purposes of applying § 482 of the Internal Revenue Code to a single transaction in which all shareholders of the corporation acted in concert, even though the shareholder, acting alone, could not control the corporation.

Statute and Regulations Involved

The statute involved is § 482 of the Internal Revenue Code of 1954, 26 U. S. C. § 482, which provides:

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* "R" refers to the portion of the printed record in the Court of Appeals entitled "APPENDIX". "Ex." refers to the Exhibit Volume from the APPENDIX. For the convenience of the Court, we have had one copy of each of these volumes certified by the Clerk of the Court of Appeals, and we are forwarding these copies with this petition.

§ 482. Allocations of income and deductions among taxpayers

> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The regulations involved are §§ 1.482-1 and 1.482-2(a) of the Income Tax Regulations [26 C. F. R. §§ 1.482-1 and 1.482-2(a)], pertinent portions of which are reprinted in the Appendix, pp. A1-A4ff.

Statement of the Case

The material facts in this case have been stipulated or found as follows:

Petitioners, both New York corporations, had operated competing retail department stores on adjacent sides of the same block in Rochester, New York, for periods in excess of fifty years prior to the taxable years in question. All of the stock of petitioner McCurdy & Company, Inc. (McCurdy's) was owned by or on behalf of members of the McCurdy family. All of the stock of petitioner B. Forman Company, Inc. (Forman's) was owned by or on behalf of members of the Forman family. McCurdy's and Forman's had no common shareholders, directors, or office (R. pp. 57a, 58a). In an effort to stem declining incomes, McCurdy's and Forman's caused Midtown Holdings Corp. (Midtown) to be formed in 1958, for the purpose of building and operating a

shopping plaza and office building complex adjoining their stores (R. pp. 58a, 93a-97a). McCurdy's and Forman's each received fifty percent of the issued and outstanding shares of Midtown when Midtown was incorporated.

On March 23, 1959, the two shareholders entered into an agreement governing their relationship and their obligations to finance Midtown during the construction of the plaza. The agreement provided that, in exchange for the transfer of various real estate interests and additional capital contributions, additional shares of Midtown were to be transferred to McCurdy's and Forman's in equal amounts. The parties also agreed to lend equal amounts to Midtown from time to time (Ex. 7-G).

The agreement required each party to designate three of the six Directors of Midtown. In the event of a deadlock on the Board, provision was made for the designation of a Justice of the Appellate Division of the Supreme Court of the State of New York, Fourth Judicial Department, to resolve the impasse (Ex. 7-G).

Although the agreement provided for the designation of three Midtown directors by each of the parties, there were only four directors acting during the periods in question. At all times, the Board of Directors was comprised of two persons representing McCurdy's interests and two persons representing Forman's interests (R. p. 59a).

On September 9, 1960, each petitioner made a loan to Midtown of $1,000,000, represented by three-year notes and bearing interest at the rate of three and one-half percent per year. These notes were cancelled in April, 1961, without payment of any principal or interest. At that time they were replaced by notes of $1,000,000 to each petitioner, predated to September 9, 1960, and bearing no interest. On

their due date of September 9, 1963, they were replaced by three-year notes in the same principal amounts, bearing no interest, and without any payment of interest or principal having been made on the original notes. These notes were replaced on September 9, 1966 by other three-year notes in the same amounts, bearing no interest, and again, without any payment of interest or principal having been made on the original notes. No payments of principal or interest have ever been made on the notes dated September 9, 1960, September 9, 1963, or September 9, 1966 (R. p. 66a). The proceeds of these loans were used by Midtown in the construction of the Midtown Plaza complex. Midtown received the bulk of its income from rentals during this period, and it had net operating losses in two of the three relevant years (Ex. 35-AI, 36-AJ, 37-AK). The Commissioner introduced no evidence that the loan proceeds generated any income or deductions for Midtown during the years in question.

On audit of the tax returns for each petitioner's fiscal years ending in 1965, 1966 and 1967, the Commissioner of Internal Revenue added $50,000 to the taxable income of each taxpayer which represented hypothetical imputed "interest" at the rate of five per cent per year on the $1,000,000 interest-free loans made by each of the petitioners to Midtown. The Commissioner based his addition of $50,000 to each of the petitioner's taxable incomes for the years in question on § 482 of the Internal Revenue Code *(supra)* which provides, in substance, that the Secretary of the Treasury may distribute, apportion, or allocate items of gross income, deductions, credits, or allowances between commonly controlled business entities, if he determines that such action is necessary in order to prevent the evasion of taxes or clearly to reflect their income (R.

pp. 39a-40a). The Commissioner did not specifically indicate which items of gross income, if any, he was attempting to "distribute, allocate or apportion," nor did he contend that the loans generated any income at all for Midtown. No allocation was made of any deductions resulting from the building constructed, in part, with the proceeds of the loans (R. pp. 25a-48a).

Following receipt of the notices of deficiency, each taxpayer filed a petition with the Tax Court for a review of the Commissioner's determination. The cases were consolidated for trial and have remained consolidated on appeal.

The Tax Court, in an opinion written by Judge Theodore Tannenwald, Jr. and reviewed by the Court without dissent, reversed the Commissioner's determination, holding that Midtown was not "controlled directly or indirectly" by either McCurdy's or Forman's and that McCurdy's and Forman's could not be regarded as a "joint venture" in control of Midtown. The Tax Court disposed of the case on this issue and was therefore not compelled to address itself to the question of whether § 482 authorizes the allocation of income where no income is realized (R. p. 43a, Appendix pp. A17ff). The United States Court of Appeals for the Second Circuit, in an opinion of District Judge Zavatt, reversed the holding of the Tax Court. It held that the fact that the taxpayers together controlled the corporation satisfied the control requirement of § 482, even though neither taxpayer and the corporation were commonly controlled. The court additionally held that the Commissioner of Internal Revenue could allocate hypothetical loan interest from a corporation to another commonly controlled business entity without showing that any item of the gross income of the corporation was attributable to the proceeds of the loan (Appendix pp. A47ff.).

The proceedings in the Tax Court and the Court of Appeals also involved the disallowance of a claimed business expense deduction. That issue is not relevant to this petition.

REASONS FOR GRANTING THE WRIT

I. Both Questions Involve Issues of General Importance in Tax Administration and in Defining the Limits of Federal Administrative Discretion. The Volume of Litigation Involving these Issues is Increasing Rapidly and Will Continue to Increase Until They are Authoritatively Settled.

The far-reaching importance of § 482 of the Internal Revenue Code of 1954 can scarcely be overstated. Since its beginnings in 1921, the present § 482 has evolved from a simple provision for the consolidation of returns to a deceptively simple looking authorization to override customary accounting practices in order "to prevent evasion of taxes or clearly to reflect" the respective incomes of related organizations.[1]

As a result of this evolution, Section 482 has attained the clear potential to become a "revenue code in itself" which would affect most large business enterprises and many small ones.[2] Furthermore, it has been thought by some commentators that the section is being perverted from

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[1] See Scieroe and Gerber, *Section 482—Still Growing at the Age of 50*, 46 TAXES 893, (December, 1968); *see also*, Aland, *Section 482: 1971 Version*, 49 TAXES 815, (December, 1971).

[2] Rogovin, *Unilateral Treatment of Multilateral Problems*, 19 Bulletin of the Section of Taxation of the American Bar Association, No. 3, April, 1966, p. 65; Cohen, *How the IRS intends to administer the new Regulations under Section 482*, 28 JOURNAL OF TAXATION 73, 74, (February, 1968).

its original purpose as a shield against tax avoidance to be used as a sword for revenue production.[3]

The litigation under § 482 is increasing exponentially. Between 1928 and 1951, 43 cases were tried under predecessor statutes. Between 1960 and 1964, 40 cases were brought.[4] In 1966, 230 groups of cases were pending under § 482, and, as of November, 1971, 511 groups representing 1,298 cases awaited disposition.[5]

The persistence of the Commissioner in seeking to expand his authority under § 482 is strong evidence of its increased importance. Notwithstanding consistent set-backs, he has continued to press for the most expansive interpretation of the statutory provisions.[6] The comparatively exhaustive regulations proposed in 1965, and made final in 1968, have evoked considerable commentary both because of their scope and because of the announcements which accompanied them and which indicated that their application in the field would be more assiduous.[7]

The commentary on §482 has increased markedly in recent years and has indicated forcefully that the issues have graduated from relatively prosaic factual questions of accounting to vital problems of administrative dis-

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[3] Spaeth, *Section 482—Past and Future*, 47 TAXES 45, 50, (January, 1969); Cohen, *Section 482: Treasury's Effort to Teach an Old Dog Some New Tricks*, 43 TAXES 835, 836; (December, 1965) P-H U. S. Taxation of International Operations ¶5001.2.

[4] Rogovin, *supra* note 2, p. 66.

[5] *Id.* p. 66; Internal Revenue Service, Reports and Information Retrieval Activity, (November, 1971).

[6] See Sections II and III of this petition, *infra*.

[7] *See* articles by Rogovin and Cohen, *supra* note 2; *see also*, Surrey, *Treasury's need to curb tax avoidance in foreign business through use of 482*, 28 JOURNAL OF TAXATION 75, (February, 1968); Rev. Rul. 65-142, 1965-1 Cum. Bull. 223.

cretion and tax administration. Of 151 articles published since 1954 dealing with § 482, 117 have appeared since 1965. Many of these articles have addressed themselves to the questions of administrative discretion raised by the expansive Treasury interpretation of the statute, and almost all of them have noted the trend toward increasing deployment of the section as a major weapon in the Commissioner's arsenal.[8]

The Commissioner has been criticized by a number of commentators for his recent attempts to employ § 482 as a "substitute for well-defined Code sections and well-established judicial principles."[9] Recently this Court held, in *First Security Bank of Utah v. Commissioner*, No. 70-305 (March 21, 1972), that the Commissioner lacked authority under § 482 to allocate to an organization income that it could not legally have received. The question now remains whether the Commissioner can "allocate" income which has not in fact been shown to exist.

The case at bar, involving as it does issues of control and creation of income, presents two of the most important issues concerning the Commissioner's discretion under § 482. Since 1954, at least 34 major articles have addressed the question of the creation of income and at least 18 have considered the problem of control.[10] The case at bar has generated a great deal of interest in the profession. Three major articles have dealt with it in some detail, and it has been the subject of wide interest in

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[8] CCH, Federal Tax Articles 1954-1967, pp. 693-705; CCH Federal Tax Articles pp. 160-162, ¶¶ 8119, 8320, 8506, 8700, 8901, 9088, 9493, 9626.

[9] Aland, *supra* note 1, p. 84.

[10] This data is obtained by a review of the articles cited in CCH Federal Tax Articles, *supra* note 8.

the financial and tax communities.[11] At every stage, the issues presented in this petition have involved only questions of law, and all relevant facts have been stipulated or introduced without opposition.

The issue of creation of income is the most far-reaching issue in the administration of § 482, and has been thought by at least one commentator to involve a constitutional question.[12] The decision of the Court of Appeals in this case will affect large numbers of taxpayers and promises to force reorganization of the very modes by which business is conducted at great expense and without a corresponding increase in profit.[13]

The issue of control and its ramifications is at the basis of a § 482 application and is, of course, the *sine qua non* for the Commissioner's authority.

II. The Decision of the Court of Appeals on the Creation of Income Question Contradicts all Indications of the Intent of Congress as Well as Established Precedent, both in Principle and in Result. The Decision Conflicts With a Sixth Circuit Decision.

It is clear from the legislative history of § 482 that the statute was not intended as an omnibus provision for the collection of revenue or the enforcement of tax laws. The

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[11] Hamlin, *Correct Allocations Under Section 482 are Still Difficult Despite New Regs*, 33 JOURNAL OF TAXATION 358, (December, 1970); Aland, *supra* note 1; Crawford, *Are the courts expanding the scope of Code Section 482?* 36 JOURNAL OF TAXATION 150, (March, 1972); *See also Wall Street Journal*, 1/26/72, p. 1 c. 5.

[12] Jenks, *The "Creation of Income" Doctrine A Comment on the Proposed Section 482 Regulations*, 43 TAXES 486, 491, (August, 1965).

[13] Spaeth, *supra* note 3, p. 53.

Ways and Means Committee Report on § 240(d) of the Revenue Act of 1921, the earliest predecessor to § 482, indicated that the provision was intended to give the Commissioner the authority to "consolidate the accounts" of related trades or businesses "for the purpose only of making an accurate distribution or apportionment of gains, profits, income, deductions, or capital between or among such related trades or businesses."[14] The Committee thought this was necessary "to prevent the arbitrary shifting of profits among related businesses, particularly in the case of subsidiary corporations organized as foreign corporations."[15]

These Congressional sentiments expressed an intention that § 482 be applied only in those cases where the arbitrary shifting of discrete items of income distorted the taxable incomes of related parties and that, in view of the drastic nature of the power to override customary accounting practices, the statute should be strictly construed.[16] Congress did not indicate a desire to reconstruct transactions between related parties as an end in itself but, rather, as a means to ensure that income *actually earned* was taxed to the real earner and not diverted to a related taxpayer.

The statement in the Report of the House Ways and Means Committee concerning §45 of the Revenue Act of 1928 that the powers of the Commissioner were "broadened considerably" by the 1928 changes in the statute reflects only the elimination of the previous Revenue Act provision

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[14] Ways and Means Committee Report on Internal Revenue Bill of 1921 (H. R. Rep. No. 350, 67th Congress, 1st Session 14), 1939-1 Cum. Bull. (Part 2) 195.

[15] *Id.*

[16] Crawford, *supra* note 11, p. 153.

requiring the Commissioner to force consolidated returns and was not a new license for the large-scale readjustment of transactions among related parties.[17]

In keeping with Congressional intent, the Court of Appeals for the Sixth Circuit has held that the Commissioner cannot create income under § 482 and is limited to allocating income that already exists. In *Tennessee-Arkansas Gravel Company v. Commissioner of Internal Revenue*, 112 F. 2d 508 (6th Cir. 1940), the taxpayer had, during the taxable year in question, allowed its subsidiary to use rent-free certain equipment for which the subsidiary had previously paid $1,000 per month. The Commissioner sought to allocate rental income of $1,000 per month to the petitioner under § 45 of the Revenue Act of 1934, a substantially identical predecessor section to § 482, without making any attempt to show that the equipment produced gross income for the subsidiary.

In rejecting the attempted creation of income by the Commissioner, the Court of Appeals for the Sixth Circuit held:

> Section 45, *supra,* did not authorize the Commissioner to set up income where none existed. The principal purpose of the section was to clearly reflect income that did exist.
>
> It is suggested that the law will imply that the Commissioner apportioned the $12,000 to petitioner from the gross income of Mississippi, but the law permits no inferences contrary to fact. (*Id.* p. 510)

In this way, the principle was reaffirmed that § 482, appearing as it does in the accounting section of the tax law, countenances only the reallocation, not the creation of income.

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[17] *Id.* p. 153.

Three years after *Tennessee-Arkansas* was decided, § 45 was amended by § 128(b) of the Revenue Act of 1943, which changed the words "gross income or deductions" to read "gross income, deductions, credits or allowances." If Congress had been dissatisfied with *Tennessee-Arkansas* it surely would have amended § 45 to reverse the result reached by the Sixth Circuit at the same time as it changed the very provisions dealing with the scope of the Commissioner's discretion.

Eleven years after *Tennessee-Arkansas*, in *Smith-Bridgman & Company*, 16 T. C. 287 (1951) Acq. 1965-1 Cum. Bull. 3, the Tax Court reaffirmed the interpretation of § 482 made in *Tennessee-Arkansas* and held that the Commissioner improperly increased the taxpayer's income by an amount deemed to represent an arms-length interest charge where the taxpayer had made interest-free loans to a related corporation. The Court noted that the application of § 45 of the 1939 Code was predicated on the existence of income that could be allocated and said, at page 293:

> . . . We think this record clearly establishes that the respondent has not distributed, apportioned, or allocated gross income, but has created or attributed income where none in fact existed.

In *Campbell County State Bank, Incorporated of Herreid, South Dakota v. Commissioner*, 311 F. 2d 374 (8th Cir. 1963), the Commissioner's allocation of expenses among two controlled corporations in proportion to their gross incomes was held to be improper because he failed to show that there was any relationship between the expenses and the gross income realized.

The Commissioner acquiesced in *Smith-Bridgman* in 1951-1 Cum. Bull. 3, and this acquiescence remained with-

out qualification for fourteen years. It was generally assumed during this period of time that the issue had been resolved. Then, in 1965, the Treasury proposed new regulations substantially similar to those now in effect. The regulations flew in the face of the principles laid down in *Tennessee-Arkansas* and *Smith-Bridgman*. As finally adopted, they purported to give the Commissioner the power to reconstruct transactions between related taxpayers so as to put them in the same position as they would have been in had they met the Commissioner's notion of "arms-length" standards. The concept of "distributing, apportioning, and allocating" income that had in fact been earned by someone was completely ignored. In fact, the regulations, in § 1.482-1(d)(5), went so far as to claim that the Commissioner could "allocate" income from a taxpayer even if that taxpayer never realized any income at all.

When the inconsistency between the proposals and the acquiescence in *Smith-Bridgman* was called to his attention, the Commissioner attempted to explain it by indicating that the *Smith-Bridgman* holding was based on his failure to make a correlative adjustment to the income of the taxpayer from whom the income was shifted. Rev. Rul. 67-79, 1967-1 Cum. Bull. 117.

The Commissioner's attempted expansion of his authority received its first judicial test in 1970, and was soundly rebuffed by the Tax Court.

In *PPG Industries, Inc.*, 55 T. C. 928 (1970), the Court once again held that § 482 does not authorize the Commissioner to impute interest by reason of interest-free loans where there is no showing that the loans created income in the year of the imputation. The court rejected the Commissioner's argument that the 5% interest rate

which he sought to apply was merely used as a formula for allocating to the taxpayer that part of the earnings of the subsidiary "attributable" to the loans. It held that the Commissioner must show what, in fact, is being allocated and cannot shift dollar amounts from one taxpayer to another pursuant to a mathematical formula bearing no relationship to the facts of the case. The court dismissed out of hand the Service's attempt to limit *Smith-Bridgman* to situations in which no correlative adjustment was made to the tax liability of the other party, indicating that this failure was a minor evidentiary factor without controlling significance.

In *Huber Homes, Inc.*, 55 T. C. 598 (1971), the Tax Court rejected an attempt by the Commissioner to shift income to the taxpayer from its wholly owned subsidiary corporation where the Commissioner failed to show that houses transferred at cost from the taxpayer to the subsidiary earned income for the subsidiary that could be "allocated" to the taxpayer. The houses were rented by the subsidiary to tenants and the subsidiary in fact sustained a loss from the rental operation. Under the circumstances, the Court properly reasoned that no income was realized by the group of controlled corporations from dealings with third parties and that, therefore, there was no income to be allocated from one member of the group to another. The arms-length standard relied on by the Commissioner was said to be appropriate where used as a method for reallocating income derived from dealings with third parties among members of the group, but the Court refused to stretch the statute so far as to authorize its use to create income within the group where none actually existed. The Court said:

> The present case closely parallels *Tennessee-Arkansas* in that the Commissioner here, as there, did not

> *allocate* to the taxpayer any of the gross income of the related party to which there was a transfer at less than arms-length. Instead, here, as there, the Commissioner *created* income out of a transaction which, in the Commissioner's opinion, only *would have* produced income had the petitioner dealt with the controlled parties at arms-length. Thus, it is apparent that the Commissioner here did not "distribute, apportion, or allocate gross income" within the meaning of section 482.

The Court expressly reaffirmed its earlier holding in *Smith-Bridgman* and rejected the Commissioner's attempt to explain that case and *Tennessee-Arkansas* in terms of his failure to make a correlative adjustment to the liability of the other taxpayer. Other cases cited were *E. C. Laster*, 43 B. T. A. 159 (1940) Acq. 1941-1 Cum. Bull. 7, *modified on other grounds*, 128 F. 2d 4 (5th Cir. 1942); *Texsun-Supply Corporation*, 17 T. C. 433 (1951) Acq. 1952-1 Cum. Bull. 4.

The basic facts in *Tennessee-Arkansas*, *PPG Industries* and *Huber Homes* are indistinguishable in any material respect from those of the instant case. In the case at bar, as in the cases cited, the Commissioner has attempted to charge a taxpayer with income by reason of a transfer of property to a related corporation without showing that the property produced any income for the related corporation that could be allocated back to the taxpayer. *PPG Industries* involved interest-free loans as does the case before this Court. In *Huber Homes*, the taxpayer transferred rental property to the related corporation; in the case at bar, money advanced was used to construct rental property.

Notwithstanding *Tennessee-Arkansas*, *Smith-Bridgman*, *PPG Industries* and *Huber Homes*, the Court of Appeals

for the Second Circuit in the present case has brushed aside the expectations of the last 32 years by begging the question, thus:

> To the extent that the above cases cited by taxpayers may be read as holding that no interest can be allocated under § 482 under the facts of this case, they are not in accord with either economic reality, or with the declared purpose of section 482. They seriously impair the usefulness of § 482. Those cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as a correlative adjustment is made to Midtown, for then the true taxable income of all involved will be properly reflected (Appendix p. A59).

The fundamental question posed is whether § 482 authorizes the Commissioner to reconstruct transactions between related taxpayers in accordance with an arms-length standard *as an end in itself* without showing that the reconstruction results in shifting income actually earned from one party to another. The Second Circuit has held that the Commissioner has this power; the Sixth Circuit and the Tax Court have disagreed. The issue affects great numbers of taxpayers throughout the country, and will be present whenever related businesses deal with one another.

The disregard of well-established and unbroken precedent by the Second Circuit in the name of "economic reality" with virtually no legal analysis and absolutely no economic analysis[18], the ensuing confusion that will be caused by the sweeping imprimatur given to the attempts

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[18] Economic reality certainly cannot be a proper subject for judicial notice in this case. *Compare* Spaeth, *supra* p. 47 and P-H U. S. Taxation of International Operations *supra* ¶ 5001.2 p. 5015, with Hewitt, *Section 482—Reallocation of Income and Deductions Between Related Persons—Up to Date*, NEW YORK UNIVERSITY TWENTY-SECOND ANNUAL INSTITUTE ON FEDERAL TAXATION, pp. 398-399, (1964).

of the Commissioner to make allocations under § 482 wherever "useful," and the different treatment of taxpayers in different parts of the country resulting from the conflict between the courts of appeals will result in continuous and costly litigation until the issue is resolved by this Court.

III. The Decision of the Court of Appeals on the Control Issue Conflicts with the Intent of Congress and with Long Established Precedent and, by Approving the Commissioner's Virtual Elimination of any Meaningful Control Requirement from § 482, Sanctions an Abuse of Accepted Standards of Administrative Discretion.

Section 482 does not give the Commissioner the authority to allocate income and deductions whenever he feels it is appropriate. The section becomes operative only where the necessary common control exists. The decision of the Court of Appeals in this case repudiates a judicial construction of this common control requirement that has gone unquestioned by the courts and Congress for twenty-five years.

In *Lake Erie and Pittsburg Railway Company*, 5 T. C. 558 (1945), Non-Acq. 1965-1 Cum. Bull. 5; Acq. 1945 Cum. Bull. 5 (withdrawn), a corporation was organized by two independent railroad companies for the purpose of acquiring, building, maintaining, leasing and operating a railroad. Each company owned 50% of the stock of the subsidiary, the taxpayer in question. The Tax Court held that the Commissioner could not allocate income from the parent corporations to the taxpayer on the ground that neither shareholder and the taxpayer were controlled by the same interests. It noted that the shareholder corporations were,

in turn, owned by different shareholders and did not constitute the same interests and said, at pages 564-565:

> . . . The stockholders of the New York Central are not the "same interests" as the stockholders of Pennsylvania. And neither the New York Central nor the Pennsylvania has control of the petitioner. Together they do have. But that amounts to saying nothing more than that the stockholders of a corporation control it. We do not think that it can be said that where two or more corporations owned by different sets of stockholders control another corporation such other corporation is controlled by the same interests. . . .

The Commissioner acquiesced in the Tax Court's holding. 1945 Cum. Bull. 5. This acquiescence remained in effect for twenty years, being withdrawn during the second of the taxable years in issue in these cases. 1965-1 Cum. Bull. 5, *explained in* Rev. Rul. 65-142, 1965-1 Cum. Bull. 223. The certainty and predictability created by this long standing administrative interpretation of the statute, continuing as it did into the period during which the advances in question were made, have now been removed by the Court of Appeals.

During the time that the *Lake Erie* case represented the only judicial authority on this question (the Commissioner made no attempt to distinguish it from the case before this Court) and the Commissioner's acquiescence was in effect, Congress had numerous opportunities to change the law. Several major revenue laws were enacted during that time and the entire Internal Revenue Code was overhauled in 1954, yet no changes were made to § 45. See H. R. Rep. No. 1337, 83rd Cong., 2d Sess. A165 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 310 (1954). The reenactment of the statute in 1954, almost ten years after the Tax Court's holding in *Lake Erie* and the Commissioner's acquiescence,

gave this interpretation the force of law. *United States v. Correll*, 389 U. S. 299, 305-306 (1967).

An examination of the legislative history of § 482 and its predecessors shows that the common control language was intended by Congress to have a limiting effect on the Commissioner.

The first predecessor of § 482 was § 240(d) of the Revenue Act of 1921 which, in the case of "two or more related trades or businesses . . .owned or controlled directly or indirectly by the same interests", authorized the Commissioner to "consolidate the accounts . . . for the purpose of making an accurate distribution or apportionment of gains, profiits, income, deductions, or capital between or among such related trades or businesses." Section 240 of the 1921 Act dealt generally with related corporations and § 240(a) provided for the filing of consolidated returns by "affiliated" corporations. The purpose of the provisions was to prevent parent corporations from manipulating subsidiaries so as to avoid taxes. H. R. Rep. No. 350, 67th Cong., 1st Sess. 14; S. Rep. No. 275, 67th Cong., 1st Sess. 20.

In the Revenue Act of 1924, § 240(d) was amended to permit the taxpayer to invoke that provision as well as the Commissioner. The language relating to control that had been used in the 1921 Act when only the Commissioner could use the provision was retained. At the same time, the provisions of § 240(a) of the Act allowing taxpayers to file consolidated returns were made more restrictive. In view of Congress' continuing concern at the time with the problem of manipulation, it is obvious that it must have felt that the words "owned or controlled directly or indirectly by the same interests" were words of limitation. Un-

der the circumstances, it is inconceivable that Congress would have granted taxpayers the privilege of shifting income, deductions and similar items around whenever some semblance of a relationship existed. It is clear that Congress intended to confer the new benefits of § 240(d) only where there was effective working control. The taxpayer's right to use § 240(d) was taken away in the Revenue Act of 1928 but the control language remained the same and has not changed to this day.

It is evident that it was and has been the intention of Congress that the application of § 482 and its predecessors should be confined to situations in which the same interests exercise effective control over two or more businesses. The common control language cannot be expanded indefinitely for the effect would be to give § 482 almost unlimited applicability to corporate dealings with shareholders and to allow the Commissioner to second-guess legitimate business judgement in all such cases. Until the decision of the Court of Appeals in this case, the courts had properly rejected any attempts by the Commissioner to expand the language.

The reasoning of the Commissioner if followed to its logical conclusion, would read the phrase "owned or controlled directly or indirectly by the same interests" out of the statute entirely.

Whenever a corporation acts, it may be assumed that there is a unity of interest among the corporation and at least 51% of its shareholders. However, unity of interest is not the test under the statute. The test is unity of control. Petitioners submit that if the Commissioner can find unity of control between a corporation and a 50% shareholder, he can find the same unity even with regard to a

10% shareholder, so long as that shareholder votes with the majority.

The Tax Court in *Lake Erie* and in the case at bar recognized that it would be a distortion of the statutory language to find that the mere existence of a common objective in a single transaction was sufficient to combine two independent competitors into a "business" for purposes of § 482. The Court of Appeals for the Second Circuit has ignored precedent as well as the intent of Congress in holding to the contrary.

Section 482 is a powerful weapon which both Congress and the courts have carefully sought to circumscribe. The erosion of the jurisdictional control requirement by the Court of Appeals for the Second Circuit in this case represents an unwarranted judicial approval of the Commissioner's increasing utilization of § 482 in unintended and inappropriate circumstances and opens up a Pandora's box of questions as to the scope of the statute. Further confusion about the limits of § 482 and considerable litigation are bound to result unless those limits are clarified by this Court.

Conclusion

For the foregoing reasons, the petition for a writ of certiorari should be granted.

Respectfully submitted,

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March 27, 1972.

SUPREME COURT, U.

71 - 1280

IN THE

Supreme Court of the United States

Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLER

October Term, 1971

B. FORMAN COMPANY, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Docket No.: .....

McCURDY & COMPANY, INC.,
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APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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APPENDIX TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

I. Relevant Treasury Regulations

§ 1.482-1. Allocation of income and deductions among taxpayers.—(a) *Definitions.* When used in this section and in § 1.482-2—

(1) The term "organization" includes any organization of any kind, whether it be a sole proprietorship, a partner-

ship, a trust, an estate, an association, or a corporation (as each is defined or understood in the Internal Revenue Code or the regulations thereunder), irrespective of the place where organized, where operated, or where its trade or business is conducted, and regardless of whether domestic or foreign, whether exempt, whether affiliated, or whether a party to a consolidated return.

(2) The term "trade" or "business" includes any trade or business activity of any kind, regardless of whether or where organized, whether owned individually or otherwise, and regardless of the place where carried on.

(3) The term "controlled" includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted.

(4) The term "controlled taxpayer" means any one of two or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests.

(5) The terms "group" and "group of controlled taxpayers" mean the organizations, trades, or businesses owned or controlled by the same interests.

(6) The term "true taxable income" means, in the case of a controlled taxpayer, the taxable income (or, as the case may be, any item or element affecting taxable income) which would have resulted to the controlled taxpayer, had it in the conduct of its affairs (or, as the case may be, in the particular contract, transaction, arrangement, or other act) dealt with the other member or members of the group at arm's length. It does not mean the income, the deductions, the credits, the allowances, or the item or element of

income, deductions, credits, or allowances, resulting to the controlled taxpayer by reason of the particular contract, transaction, or arrangement, the controlled taxpayer, or the interests controlling it, chose to make (even though such contract, transaction, or arrangement be legally binding upon the parties thereto).

(b) *Scope and purpose.* (1) The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer. The interests controlling a group of controlled taxpayers are assumed to have complete power to cause each controlled taxpayer so to conduct its affairs that its transactions and accounting records truly reflect the taxable income from the property and business of each of the controlled taxpayers. If, however, this has not been done, and the taxable incomes are thereby understated, the district director shall intervene, and, by making such distributions, apportionments, or allocations as he may deem necessary of gross income, deductions, credits, or allowances, or of any item or element affecting taxable income, between or among the controlled taxpayers constituting the group, shall determine the true taxable income of each controlled taxpayer. The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(2) Section 482 and this section apply to the case of any controlled taxpayer, whether such taxpayer makes a separate or a consolidated return. If a controlled taxpayer makes a separate return, the determination is of its true separate taxable income. If a controlled taxpayer is a party to a consolidated return, the true consolidated tax-

able income of the affiliated group and the true separate taxable income of the controlled taxpayer are determined consistently with the principles of a consolidated return.

(3) Section 482 grants no right to a controlled taxpayer to apply its provisions at will, nor does it grant any right to compel the district director to apply such provisions. It is not intended (except in the case of the computation of consolidated taxable income under a consolidated return) to effect in any case such a distribution, apportionment, or allocation of gross income, deductions, credits, or allowances, or any item of gross income, deductions, credits, or allowances, as would produce a result equivalent to a computation of consolidated taxable income under subchapter A, chapter 6 of the Code.

(c) *Application.* Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes. In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances. The authority to determine true taxable income extends to any case in which either by inadvertence or design the taxable income, in whole or in part, of a controlled taxpayer, is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer.

(d) *Method of allocation.* (1) The method of allocating, apportioning, or distributing income, deductions,

credits, and allowances to be used by the district director in any case, including the form of the adjustments and the character and source of amounts allocated, shall be determined with reference to the substance of the particular transactions or arrangements which result in the avoidance of taxes or the failure to clearly reflect income. The appropriate adjustments may take the form of an increase or decrease in gross income, increase or decrease in deductions (including depreciation), increase or decrease in basis of assets (including inventory), or any other adjustment which may be appropriate under the circumstances. See § 1.482-2 for specific rules relating to methods of allocation in the case of several types of business transactions.

(2) Whenever the district director makes adjustments to the income of one member of a group of controlled taxpayers (such adjustments being referred to in this paragraph as "primary" adjustments) he shall also make appropriate correlative adjustments to the income of any other member of the group involved in the allocation. The correlative adjustments shall actually be made if the U. S. income tax liability of the other member would be affected for any pending taxable year. Thus, if the district director makes an allocation of income, he shall not only increase the income of one member of the group, but shall decrease the income of the other member if such adjustment would have an effect on the U. S. income tax liability of the other member for any pending taxable year. For the purposes of this sub-paragraph, a "pending taxable year" is any taxable year with respect to which the U. S. income tax return of the other member has been filed by the time the allocation is made, and with respect to which a credit or refund is not barred by the operation of any law or rule of law. If a correlative adjustment is not actually made because it

would have no effect on the U. S. income tax liability of the other member involved in the allocation for any pending taxable year, such adjustment shall nevertheless be deemed to have been made for the purpose of determining the U. S. income tax liability of such member for a later taxable year, or for the purposes of determining the U. S. income tax liability of any person for any taxable year. The district director shall furnish to the taxpayer with respect to which the primary adjustment is made a written statement of the amount and nature of the correlative adjustment which is deemed to have been made. For purposes of this subparagraph, a primary adjustment shall not be considered to have been made (and therefore a correlative adjustment is not required to be made) until the first occurring of the following events with respect to the primary adjustment:

(i) The date of assessment of the tax following execution by the taxpayer of a Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment) with respect to such adjustment,

(ii) Acceptance of a Form 870-AD (Offer of Waiver of Restriction on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment),

(iii) Payment of the deficiency,

(iv) Stipulation in the Tax Court of the United States, or

(v) Final determination of tax liability by offer-in-compromise, closing agreement, or court action.

The principles of this subparagraph may be illustrated by the following examples in each of which it is assumed that

X and Y are members of the same group of controlled entities and that they regularly compute their incomes on the basis of a calendar year:

Example (1). Assume that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length rental charge for Y's use of X's tangible property in 1966; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. The primary adjustment is therefore considered to have been made in 1968. Assume further that both X and Y are United States corporations and that Y had net operating losses in 1963, 1964, 1965, 1966, and 1967. Although a correlative adjustment would not have an effect on Y's U. S. income tax liability for any pending taxable year, an adjustment increasing Y's net operating loss for 1966 shall be deemed to have been made for the purposes of determining Y's U. S. income tax liability for 1968 or a later taxable year to which the increased operating loss may be carried. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (2). Assume that X and Y are United States corporations; that X is in the business of rendering engineering services; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length fee for the rendition of engineering services by X in 1966 relating to the construction of Y's factory; that X consents to an assessment reflecting such adjustment by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Assume further that fees for such services would properly constitute a capital expenditure by Y, and that Y does not

place the factory in service until 1969. Although a correlative adjustment (increase in basis) would not have an effect on Y's U. S. income tax liability for a pending taxable year, an adjustment increasing the basis of Y's assets for 1966 shall be deemed to have been made in 1968 for the purpose of computing allowable depreciation or gain or loss on disposition for 1969 and any future taxable year. The district director shall notify X in writing of the amount and nature of the adjustment which is deemed to have been made to Y.

Example (3). Assume that X is a U. S. taxpayer and Y is a foreign taxpayer not engaged in a trade or business in the United States; that in 1968 the district director proposes to adjust X's income for 1966 to reflect an arm's length interest charge on a loan made to Y; that X consents to an assessment reflecting such allocation by executing a Waiver, Form 870; and that an assessment of the tax with respect to such adjustment is made in 1968. Although a correlative adjustment would not have an effect on Y's U. S. income tax liability, an adjustment in Y's income for 1966 shall be deemed to have been made in 1968 for the purposes of determining the amount of Y's earnings and profits for 1966 and subsequent years, and of any other effect it may have on any person's U. S. income tax liability for any taxable year. The district director shall notify X in writing of the amount and nature of the allocation which is deemed to have been made to Y.

(3) In making distributions, apportionments, or allocations between two members of a group of controlled entities with respect to particular transactions, the district director shall consider the effect upon such members of an arrangement between them for reimbursement within a reasonable period before or after the taxable year if the taxpayer can

establish that such an arrangement in fact existed during the taxable year under consideration. The district director shall also consider the effect of any other nonarm's length transaction between them in the taxable year which, if taken into account, would result in a setoff against any allocation which would otherwise be made, provided the taxpayer is able to establish with reasonable specificity that the transaction was not at arm's length and the amount of the appropriate arm's length charge. For purposes of the preceding sentence, the term arm's length refers to the amount which was charged or would have been charged in independent transactions with unrelated parties under the same or similar circumstances considering all the relevant facts and without regard to the rules found in § 1.482-2 by which certain charges are deemed to be equal to arm's length. For example, assume that one member of a group performs services which benefit a second member, which would in itself require an allocation to reflect an arm's length charge for the performance of such services. Assume further that the first member can establish that during the same taxable year the second member engages in other nonarm's length transactions which benefit the first member, such as by selling products to the first member at a discount, or purchasing products from the first member at a premium, or paying royalties to the first member in an excessive amount. In such case, the value of the benefits received by the first member as a result of the other activities will be set off against the allocation which would otherwise be made. If the effect of the set-off is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the United States tax liability of any member, allocations will be made to reflect the correct amount of each

category of income or deductions. In order to establish that a set-off to the adjustments proposed by the district director is appropriate, the taxpayer must notify the district director of the basis of any claimed set-off at any time before the expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of proposed adjustments or before July 16, 1968, whichever is later. The principles of this subparagraph may be illustrated by the following examples, in each of which it is assumed that P and S are calendar year corporations and are both members of the same group of controlled entites:

Example (1). P performs services in 1966 for the benefit of S in connection with S's manufacture and sale of a product. S does not pay P for such services in 1966, but in consideration for such services, agrees in 1966 to pay P a percentage of the amount of sales of the product in 1966 through 1970. In 1966 it appeared this agreement would provide adequate consideration for the services. No allocation will be made with respect to the services performed by P.

Example (2). P renders services to S in connection with the construction of S's factory. An arm's length charge for such services, determined under paragraph (b) of § 1.482-2, would be $100,000. During the same taxable year P makes available to S a machine to be used in such construction. P bills S $125,000 for the services, but does not bill for the use of the machine. No allocation will be made with respect to the excessive charge for services or the undercharge for the machine if P can establish that the excessive charge for services was equal to an arm's length charge for the use of the machine, and if the taxable

income and income tax liabilities of P and S are not distorted.

Example (3). Assume the same facts as in example (2), except that, if P had reported $25,000 as rental income and $25,000 less service income, it would have been subject to the tax on personal holding companies. Allocations will be made to reflect the correct amounts of rental income and service income.

(4) If the members of a group of controlled taxpayers engage in transactions with one another, the district director may distribute, apportion, or allocate income, deductions, credits, or allowances to reflect the true taxable income of the individual members under the standards set forth in this section and in § 1.482-2 notwithstanding the fact that the ultimate income anticipated from a series of transactions may not be realized or is realized during a later period. For example, if one member of a controlled group sells a product at less than an arm's length price to a second member of the group in one taxable year and the second member resells the product to an unrelated party in the next taxable year, the district director may make an appropriate allocation to reflect an arm's length price for the sale of the product in the first taxable year, notwithstanding that the second member of the group had not realized any gross income from the resale of the product in the first year. Similarly, if one member of a group lends money to a second member of the group in a taxable year, the district director may make an appropriate allocation to reflect an arm's length charge for interest during such taxable year even if the second member does not realize income during such year. The provisions of this subparagraph apply even if the gross income contemplated

from a series of transactions is never, in fact, realized by the other members.

(5) Section 482 may, when necessary to prevent the avoidance of taxes or to clearly reflect income, be applied in circumstances described in sections of the Code (such as section 351) providing for nonrecognition of gain or loss. See, for example, *National Securities Corporation v. Commissioner of Internal Revenue*, 137 F. 2d 600 (3rd Cir. 1943), cert. denied 320 U. S. 794 (1943).

(6) If payment or reimbursement for the sale, exchange, or use of property, the rendition of services, or the advance of other consideration among members of a group of controlled entities was prevented, or would have been prevented, at the time of the transaction because of currency or other restrictions imposed under the laws of any foreign country, any distributions, apportionments, or allocations which may be made under section 482 with respect to such transactions may be treated as deferrable income or deductions, providing the taxpayer has, for the year to which the distributions, apportionments, or allocations relate, elected to use a method of accounting in which the reporting of deferrable income is deferred until the income ceases to be deferrable income. Under such method of accounting, referred to in this section as the deferred income method of accounting, any payments or reimbursements which were prevented or would have been prevented, and any deductions attributable directly or indirectly to such payments or reimbursements, shall be deferred until they cease to be deferrable under such method of accounting. If such method of accounting has not been elected with respect to the taxable year to which the allocations under section 482 relate, the taxpayer may elect such method with respect to such allocations (but not with

respect to other deferrable income) at any time before the first occurring of the following events with respect to the allocations:

(i) Execution by the taxpayer of Form 870 (Waiver of Restrictions on Assessment and Collection of Deficiency in Tax and Acceptance of Overassessment);

(ii) Expiration of the period ending 30 days after the date of a letter by which the district director transmits an examination report notifying the taxpayer of the proposed adjustments reflecting such allocations or before July 16, 1968, whichever is later; or

(iii) Execution of a closing agreement or offer-in-compromise. The principles of this subparagraph may be illustrated by the following example in which it is assumed that X, a domestic corporation, and Y, a foreign corporation, are members of the same group of controlled entities:

Example. X, which is in the business of rendering a certain type of service to unrelated parties, renders such services for the benefit of Y in 1965. The direct and indirect costs allocable to such services are $60,000, and an arm's length charge for such services is $100,000. Assume that the district director proposes to increase X's income by $100,000, but that the country in which Y is located would have blocked payment in 1965 for such services. If, prior to the first occurring of the events described in subdivisions (i), (ii), or (iii) of this subparagraph, X elects to use the deferred income method of accounting with respect to such allocation, the $100,000 allocation and the $60,000 of costs are deferrable until such amounts cease to be deferrable under X's method of accounting. [Reg. § 1.482-1.]

§ 1.482-2. Determination of taxable income in specific situations.—(a) *Loans or advances*—(1) *In general.* Where

one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest, or charges interest at a rate which is not equal to an arm's length rate as defined in subparagraph (2) of this paragraph, the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan or advance.

(2) *Arm's length interest rate.* For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which was charged, or would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. All relevant factors will be considered, including the amount and duration of the loan, the security involved, the credit standing of the borrower, and the interest rate prevailing at the situs of the lender or creditor for comparable loans. If the creditor was not regularly engaged in the business of making loans or advances of the same general type as the loan or advance in question to unrelated parties, the arm's length rate for purposes of this paragraph shall be—

(i) The rate of interest actually charged if at least 4 but not in excess of 6 percent per annum simple interest,

(ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was less than 4, or in excess of 6 percent per annum simple interest, unless the taxpayer establishes a more appropriate rate under the standards set forth in the first sentence of this subparagraph. For purposes of the preceding sentence if the rate actually charged is greater than 6 percent per annum simple interest and less than the rate determined

under the standards set forth in the first sentence of this subparagraph, or if the rate actually charged is less than 4 percent per annum simple interest and greater than the rate determined under the standards set forth in the first sentence of this subparagraph, then the rate actually charged shall be deemed to be a more appropriate rate under the standards set forth in the first sentence of this subparagraph. Notwithstanding the other provisions of this subparagraph if the loan or advance represents the proceeds of a loan obtained by the lender at the situs of the borrower the arm's length rate shall be equal to the rate actually paid by the lender increased by an amount which reflects the costs or deductions incurred by the lender in borrowing such amounts and making such loans, unless the taxpayer establishes a more appropriate rate under the standards set forth in the first sentence of this subparagraph.

(3) *Loans or advances to which subparagraph (1) applies.* Subparagraph (1) of this paragraph applies to all forms of bona fide indebtedness and includes:

(i) Loans or advances of money or other consideration (whether or not evidenced by a written instrument), and

(ii) Indebtedness arising in the ordinary course of business out of sales, leases, or the rendition of services by or between members of the group, or any other similar extension of credit.

Subparagraph (1) of this paragraph does not apply to alleged indebtedness which was in fact a contribution of capital or a distribution by a corporation with respect to its shares. The interest period shall commence at the date the indebtedness arises, except that with respect to indebtedness described in subdivision (ii) of this subparagraph that

is not evidenced by a written instrument requiring payment of interest, the interest period shall not commence until a date 6 months after the date the indebtedness arises, or until a later date if the taxpayer is able to demonstrate that either it or others in its industry, as a regular trade practice, permit comparable balances in the case of similar transactions with unrelated parties to remain outstanding for a longer period without charging interest. For the purpose of determining the period of time for which a balance is outstanding, payments or credits shall be applied against the earliest balance outstanding, unless the taxpayer applies such payments or credits in some other order on its books in accordance with an agreement or understanding of the parties if the taxpayer can demonstrate that either it or others in its industry, as a regular trade practice, enter into such agreements or understandings.

II. Opinion of the Tax Court

54 T. C. No. 88

UNITED STATES TAX COURT

B. FORMAN COMPANY, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

McCURDY & COMPANY, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Docket Nos. 468-69, 469-69.

(Filed May 4, 1970.)

In 1958, petitioners organized Midtown Holding Corp. for the purpose of constructing and operating an enclosed mall shopping center adjacent to their department stores. They had equal ownership and control of Midtown. The shopping center opened for business in 1962. During the years in issue, Midtown paid no interest on certain loans made to it by petitioners. In addition, petitioners made certain equal payments to Midtown ostensibly to prevent the erection of kiosks in the part of the mall adjacent to

their stores. *Held,* that respondent may not utilize sec. 482, I. R. C. 1954, to impute interest income to petitioners on said loans, since Midtown and petitioners were not controlled, directly or indirectly, by the same interests. *Held, further,* that, at least by 1962, Midtown had decided in its own interest not to erect kiosks, with the result that purported kiosk prevention payments constituted disguised capital contributions to Midtown, and not ordinary and necessary business expenses within the meaning of sec. 162, I. R. C. 1954.

Ellsworth A. Van Graafeiland, Peter L. Faber, and *William M. Colby,* for the petitioners.

Marvin E. Hagen and *Stephen M. Miller,* for the respondent.

TANNENWALD, *Judge:* Respondent has determined deficiencies in petitioners' Federal income taxes as follows:

Petitioner	*Taxable Year ending*	*Deficiency*
B. Forman Company, Inc.	January 30, 1965	$66,025.55
	January 29, 1966	58,775.14
	January 28, 1967	59,692.00
McCurdy & Company, Inc.	January 30, 1965	59,181.99
	January 29, 1966	61,323.29
	January 28, 1967	62,343.56

Only two issues were raised in the petitions:

(1) Whether respondent properly imputed to petitioners interest income on certain loans made by pettioners to a corporation, pursuant to section 482[1]; and

(2) Whether certain payments petitioners made to a corporation in which they were sole and equal shareholders

[1] All references, unless otherwise noted, are to the Internal Revenue Code of 1954.

are ordinary and necessary business expenses, deductible under section 162.

Findings of Fact

Some of the facts have been stipulated and are so found.

Both petitioners are corporations organized under the laws of New York. Each had its principal place of business at Rochester, New York, at the time of filing its petition herein. Each petitioner filed its corporate income tax returns for the taxable years herein in issue with the district director of internal revenue, Buffalo, New York.

McCurdy & Company, Inc. (hereinafter McCurdy's) operates a general department store located on Main Street East in Rochester. B. Forman Company, Inc. (hereinafter Forman's) operates a department store specializing in men's and women's apparel located on Clinton Avenue South in Rochester. The two stores are located on adjacent sides of the same block and are competitors.

During all times herein relevant, the stock of McCurdy's was owned primarily by or for members of the McCurdy family. The stock of Forman's was owned by Maurice R. Forman and by Fred S. Forman or his estate. McCurdy's and Forman's had no shareholders, directors, or officers in common.

During the 1950's, the gross sales of Forman's declined rapidly. McCurdy's experience at its downtown store[2] was similar. These difficulties reflected a general decline in the downtown area of Rochester. Since both petitioners owned the land upon which their stores stood, this decline concerned them not only in connection with the prosperity of

[2] McCurdy's appears to have had suburban branch stores; not material herein.

their businesses, but also in connection with the value of their real estate investment.

In 1958, petitioners organized Midtown Holdings Corp. (hereinafter Midtown) for the purpose of constructing and operating an enclosed mall shopping center adjoining the two stores. This project was intended to revitalize petitioners' business and protect and enhance their real estate investment.

On March 23, 1959, petitioners entered into an agreement pertaining to their investment in Midtown. The agreement provided that McCurdy's and Forman's should each have equal representation on the Board of Directors of Midtown. Provision was made for the designation of an additional odd-numbered director, if either party so requested. Such additional director was to be selected by mutual consent or, if such consent was not forthcoming, by an independent third party.

In accordance with the agreement and at the times relevant herein, Midtown had four directors: Gilbert J. C. McCurdy, Gordon W. McCurdy, Maurice R. Forman, and Fred Forman until his death in 1963, when he was replaced by Robert Aex. During the same period, the officers of Mid-town were:

President	Gilbert J. C. McCurdy
Vice President	Maurice R. Forman
Secretary	Gordon W. McCurdy
Treasurer	Fred Forman (until his death in September 1963). Robert Aex (replaced Fred Forman in November 1963).
Vice President and General Manager	Lynn Johnston (to April 1, 1963). Angelo Chiarella (from May 27, 1963).

The 1959 agreement also provided that stock purchases from Midtown should be made equally by each petitioner and, in accordance with this provision, each petitioner in due course acquired for value an equal number of shares of common stock of Midtown. The agreement further provided, in part, that:

> VII. The parties hereto agree to loan to Midtown additional amounts so that their aggregate loans to Midtown shall be One Million Dollars ($1,000,000) each, at any time and from time to time, if, prior to January 1, 1965, the Board of Directors of Midtown, by resolution, shall determine that such additional funds in the form of borrowing are necessary or advisable. Loans shall be made equally by the parties.
>
> Such loans shall be represented by notes, or other evidence of indebtedness, of Midtown, the essential features of which shall be as follows:
>
> (A) The notes shall pay interest at the rate of five (5) percent per annum payable semi-annually on the first days of January and July in each year.
>
> (B) The notes shall be due and payable thirty (30) years after issuance.
>
> (C) Midtown shall have the right to prepay the notes in whole or in part on any interest paying date prior to maturity upon the payment of the principal amount thereof and accrued interest.
>
> (D) The notes may be unsecured but shall not be subordinated to the claims of any other unsecured creditor of Midtown.
>
> (E) The notes shall be part of a series, and there shall be no preference between the parties hereto as payment of the notes of a series.

Midtown began construction of the shopping center in 1959. The costs of construction had initially been estimated at $8,000,000; they turned out to be far higher, eventualy amounting to about $18,000,000.

During 1958 and the first four months of 1959, each petitioner made a number of loans to Midtown. On May 1, 1959, these loans were consolidated into single obligations totalling $662,500 to each petitioner in the form of 30-year notes bearing interest at 5 percent. In July 1959, Midtown satisfied these notes, without payment of interest, from the proceeds of a $2,700,000 line of credit established by Midtown with the Lincoln Rochester Trust Company.

On September 9, 1960, each petitioner loaned to Midtown $1,000,000, receiving in return a three-year note bearing interest at 3½ percent. In April 1961, these notes were cancelled without payment of principal or interest and replaced by three-year notes in the same principal amount, bearing no interest and dated back to September 9, 1960. When the notes fell due, on September 9, 1963, they were replaced by new three-year notes. These notes were in turn replaced by new three-year notes on September 9, 1966. None of these notes bore interest and no payments have ever been made on any of them. The loans evidenced by these 1963 and 1966 notes are the subject matter of the interest issue involved in this case.

During 1961 through 1963, Forman's loaned an additional $1,445,000 to Midtown, which was fully repaid in December 1964 from the proceeds of loans which Midtown secured from the Lincoln Rochester Trust Company. Also during 1961 through 1963, Gilbert J. C. McCurdy, Virginia G. McCurdy, and Maurice Forman made various loans totalling $1,895,000 to Midtown. These loans also were paid off in December 1964 with the proceeds of a Lincoln Rochester Trust Company loan.

The enclosed mall shopping center was named Midtown Plaza Shopping Center and is hereinafter referred to as Midtown Plaza. Midtown Plaza is constructed around a

mall which measures 300 feet north and south and is hereinafter referred to as the Mall. Over most of its length, the Mall is 110 feet wide, but in the northernmost 90 feet or so there is an alcove opening out to the east which makes the Mall close to 200 feet wide. The entire northern border of the Mall is taken up by McCurdy's, except for an arcade going through to Euclid Street. Forman's borders the Mall on the west, taking up approximately the northern half of the western border. The remaining borders of the Mall are occupied by a miscellany of different stores.

The Mall is entirely roofed over; the decorated ceiling is 45 feet above the main level. There is a terrace level of stores which front on a broad balcony 16 feet above the main level.

Forman's has 145 feet of frontage, three entrances, and seven display windows on the main level. On the terrace level, Forman's has 145 feet of frontage, two entrances (one blocked off), and eight display windows. McCurdy's has 214 feet of frontage (including frontage on the corridor leading off to the northeastern arcade), two entrances, and six display windows on the main level and 76 feet of frontage and two display windows on the terrace level. Pillars approximately 18 inches square support the balcony's inside edge.

One means of access to the terrace level is a pair of escalators athwart the open part of the Mall; at this point the Mall is bridged over by a causeway connecting the balconies on either side of the Mall. The escalators debouch onto this causeway. The escalators and causeway effectively divide the Mall into two unequal parts. The southern part is approximately 90 feet by 110 feet and is referred to as the "South Mall"; the northern part is approximately 180 feet by 110 feet (not including the alcove

at the northeast corner) and is referred to as the "North Mall." The North Mall thus has roughly twice the area of the South Mall.

In addition to the Mall itself, Midtown constructed and owns an 18-story building abutting the southern end of the Mall; one of the floors opens out onto the main level of the Mall. Midtown also constructed and owns a four-story building which abuts onto the alcove at the northeast corner of the Mall. An arcade goes through this building to Euclid Street, thus providing access to Midtown Plaza from the northeast. Below the southern end of Midtown Plaza is a three-level underground parking garage with a capacity of 1,700 automobiles. An escalator from the garage opens directly onto the South Mall. A bus terminal is located outside the southeastern corner of Midtown Plaza and there are pedestrian passageways leading directly into the South Mall. Buses using the terminal run frequently throughout the day and service many suburban areas near Rochester.

Midtown has constructed and rented four different kiosks in the South Mall; at any one time, however, there have been no more than three kiosks there. American Airlines rented a kiosk of 125 square feet at a rental of $26.10 per square foot during each of the years herein in issue. John T. Nothnagle, Inc., a real estate concern, rented a 60-foot kiosk at $40.35 per square foot during 1964 through 1966. The National Key Company rented a kiosk of 64 square feet during 1964-1967. The base rental in each year was $23.48 per square foot. The total rental in each year was $67.16 per square foot in 1964, $58.13 in 1965, $69.37 in 1966, and $72.27 in 1967. In 1967, the Allstate Insurance Company rented 100 square feet of floor space at $54 per square foot.

The North Mall contains a pool with a fountain, a large pit filled with earth and planted with indoor plants, and

a permanent exhibit known as the Clock of Nations. This clock is 25 feet high. Around its base are a series of cylinders containing animated dolls; these dolls are dressed in costumes characteristic of various foreign countries. At appropriate times, each cylinder is lit up, the dolls within move, and music characteristic of the particular country is played automatically. The Clock of Nations is considered a focus of interest at Midtown Plaza and a significant attraction to tourists and shoppers. To be fully effective, it was necessary that the clock be visible from as large a part of the North Mall as possible. The North Mall also contains a small structure which acts as a bulletin board for advertisements and announcements of community events.

The architect who designed Midtown Plaza initially contemplated that both parts of the Mall would have kiosks. At a late stage in the construction, it was decided to save money by cutting out unnecessary costs. The possibility of making no provision at all for kiosks was explored. But construction was so far advanced that very little, if any, money would have been saved by eliminating the utility pits for the kiosks. However, certain planned plumbing and lighting facilities for kiosks were omitted. The installation and placement of utility pits did not commit Midtown to any particular number or placement of kiosks: several kiosks could be serviced from one utility pit.

The design of a kiosk varies widely with the type of tenant for which it is intended, so widely that there is no point in building the kiosk until the nature of the tenant is known.

Midtown Plaza opened for business on April 10, 1962. At that time, there were no kiosks in the North Mall and none were contemplated. Midtown had decided to keep the

North Mall available for non-commercial events and exhibits—civic, cultural, educational, social, etc. The presence of kiosks would have made the North Mall physically less useful for such activities, some of which would require a large open space. In addition, the presence of kiosks with mercantile tenants would have given the North Mall an excessively commercial aura, incompatible with many non-commercial activities.

The North Mall has in fact been extensively used for non-commercial activities, including a National Aeronautics and Space Administration exhibit, a high school dance, and a non-denominational Easter sunrise religious service. These events and exhibits have attracted considerable pedestrian traffic to Midtown Plaza. Even more importantly, they have occasioned considerable publicity, which in turn, has made Midtown Plaza better known, kept Midtown Plaza in the minds of the residents of the Rochester area, and generated good will. In effect, making the North Mall available for non-commercial purposes has served as a very effective form of institutional advertising for Midtown Plaza as a whole. Space on the North Mall is normally made available for use free of charge, but Midtown has occasionally charged and received a fee for its use.

The advertising, with the generalized good will it built up, made Midtown Plaza a more attractive business location for merchants; the advertising thus had long-run benefits to Midtown, since it placed Midtown in a better position to charge higher rents in later years. Petitioners' businesses also benefited from this advertising, since their stores were identified with Midtown Plaza in the public mind. The businesses of the other mercantile tenants of Midtown Plaza benefited from this advertising. Since

most such tenants were on percentage leases, Midtown would in all probability immediately share in these benefits through increased rental receipts.

From the point of view of Midtown's independent economic interest, the use of the North Mall as it was in fact used, for non-commercial activities, was preferable to using it for commercial kiosks, even without payments by petitioners in lieu of kiosk rentals. The immediate and long-term benefits to Midtown from the advertising effect outweighed the loss of potential kiosk rental payments.

From the point of view of the owner of an enclosed mall shopping center, kiosks are desirable, other things being equal, since they generally increase the total rental to be expected from the entire project. But from the point of view of a store tenant, they are undesirable in that they obstruct the free flow of pedestrian traffic and, under some circumstances, may block the vision of potential customers. Insofar as petitioners were concerned, the presence of kiosks would not have materially interfered with the vision of potential customers.

In May 1963, Angelo Chiarella (hereinafter Chiarella), who had worked for the architect who designed Midtown Plaza, became vice president and general manager of Midtown under an oral agreement as to his duties and compensation. A written employment contract was executed in August 1964 and was subsequently modified in 1966. Chiarella was entitled, in addition to a base salary, to bonuses based on Midtown's "operating income." In general, Midtown's then current income had to increase substantially before Chiarella would get any bonus at all. Such an increase in Midtown's operating income would increase Chiarella's bonus. Chiarella has, in fact, received bonuses under this formula (as modified in 1966).

Since the completion of construction, Midtown's income has come largely from rental of space in Midtown Plaza. The owners of all stores adjoining the Mall, including petitioners, made payments during the years in question to Midtown to cover the cost of operating and maintaining the common mall area upon which their stores fronted. Midtown's profit and loss statements are prepared on the basis of a fiscal year ending July 31. The profit and loss statement for each of the years herein relevant shows a net loss, except for the year ending July 31, 1967, as to which the statement shows a small profit. At least during 1964 and 1965, Midtown was in need of working capital. Midtown had no taxable income subject to Federal tax during the years herein in issue.

During the years in issue, McCurdy's reported gross sales and taxable income as follows:

Year ending	*Gross sales*	*Taxable income*
Jan. 30, 1965	$22,536,052.21	$ 780,137.30
Jan. 29, 1966	24,116,410.91	1,155,580.84
Jan. 28, 1967	25,184,893.61	1,216,421.17

During the years in issue, Forman's reported gross sales and taxable income as follows:

Jan. 30, 1965	$10,077,631.00	$286,420.00
Jan. 29, 1966	10,807,663.00	420,264.00
Jan. 28, 1967	11,041,748.00	425,144.00

On May 7, 1964, Chiarella wrote a letter to each petitioner, proposing that each petitioner pay Midtown $75,000 per year not to rent out kiosks on the North Mall. The letter pointed out that petitioners benefited from the non-commercial events held in the North Mall. To justify the amount requested, the letter argued that ten kiosks could

be put into the North Mall and that $150,000 per year could be obtained in rentals from ten kiosks in that location. On November 6, 1964, petitioners and Midtown executed a written contract embodying this proposal. Under the contract, Midtown was to "retain complete control, direction and management" of the North Mall. Each petitioner agreed to pay Midtown $75,000 per year, starting with the year beginning February 1, 1964. Each petitioner paid Midtown $75,000 during each of the taxable years involved herein. The sums were included in Midtown's "operating income" for the purpose of computing Chiarella's bonus. None of Midtown's tenants has ever been approached by Midtown to make payments for the purpose of preventing the establishment of kiosks in the shopping mall, and no such payments have ever been made. None of the leases prohibits the erection of kiosks and only one lease restricts the placement of kiosks.

Advertising expenses are usually about 5 percent of the gross sales of department stores. During the years in issue, McCurdy's advertising and publicity expenditures, counting the $75,000 payments to Midtown as advertising, ranged from 3.7 percent to 4.1 percent of gross sales. During the years in issue, Forman's advertising and publicity expenditures, counting the $75,000 payments to Midtown as advertising, ranged from 3.7 percent to 3.9 percent of gross sales.

ULTIMATE FINDINGS OF FACT

1. Neither petitioner was directly or indirectly controlled by the same interests, nor was Midtown and either of the petitioners so owned or controlled.

2. Had Midtown decided to construct and rent kiosks on the North Mall, it could have realized at least $150,000

annually during the periods relevant herein in rents from such kiosks.

3. At least by April 10, 1962, when Midtown Plaza opened for business, Midtown had made a firm decision not to construct and rent kiosks on the North Mall and such decision continued in full force and effect during all periods relevant herein.

4. The $75,000 paid to Midtown by each petitioner in each of the taxable years herein in issue did not constitute an ordinary and necessary business expense.

OPINION

Imputation of Interest Income under Section 482

Each petitioner owns and operates a department store in downtown Rochester, New York. In 1958, petitioners organized Midtown Holdings Corporation as a vehicle for constructing and operating an enclosed mall shopping center abutting upon their department stores. It was hoped that the shopping center would not only revitalize their business, but also enhance the value of their real estate investment.

The project (know as Midtown Plaza) turned out to be far more expensive than expected. In consequence, petitioners from time to time made various loans to Midtown. As our findings of fact show, no interest was paid on these loans. With respect to $1,000,000 of such loans, originally made in equal amounts in September 1960 and renewed in September 1963 and again in September 1966, respondent has imputed interest income at 5 percent per annum to each petitioner. In so doing, respondent has relied on

section 482[3] and the regulations issued thereunder. See section 1.482-2(a), Income Tax Regs.

At all relevant times Forman's and McCurdy's were the sole shareholders of Midtown, each owning 50 percent of its issued and outstanding stock. Members of the Forman family controlled Forman's and members of the McCurdy family controlled McCurdy's. There is not the slightest suggestion in the record that any members of the McCurdy family and the Forman family were in any way related and respondent has made no contention in this respect.

Section 482 grants respondent authority to allocate income, deductions, credits, and allowances among two or more "organizations, trades or businesses * * * owned or controlled directly or indirectly by the same interests." This means actual, practical control rather than any particular percentage of stock ownership. *South Texas Rice Warehouse Co. v. Commissioner*, 366 F. 2d 890, 894-896 (C. A. 5, 1966), affirming 43 T. C. 540, 561-562 (1965); *Jesse E. Hall, Sr.*, 32 T. C. 390, 409-410 (1959), affd. 294 F. 2d 82 (C. A. 5, 1961); section 1.482-1(a)(3), Income Tax Regs. Respondent contends, and petitioners deny, that the requisite control existed. We agree with petitioners.

Each petitioner had only a 50-percent interest in Midtown, but this, standing alone, would not enable it to

[3] SEC. 482. ALLOCATION OF INCOME AND DEDUCTIONS AMONG TAXPAYERS.

In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

dominate or manipulate Midtown. With the possible exception of forcing a dissolution (see N. Y. Bus. Corp. Law, sec. 1104 (6 McKinney)), the best that either petitioner acting alone could achieve was a deadlock. There was no relationship between the shareholders of petitioners which could form the basis for finding that any group of shareholders could be said to have control of both Forman's and McCurdy's and thus, control of Midtown as well. It was just such a relationship which supported a finding of control in *Advance Machinery Exch. v. Commissioner*, 196 F. 2d 1006 (C. A. 2, 1952), affirming a Memorandum Opinion of this Court, *Grenada Industries, Inc.*, 17 T. C. 231 (1951), affd. 202 F. 2d 873 (C. A. 5, 1953), and *Jesse E. Hall, Sr., supra*, heavily relied upon by respondent. In *Advance Machinery* and *Hall*, the necessary relationship rested on family solidarity, and in *Grenada Industries*, it stemmed from a proportional common ownership of the entities involved. These cases are consequently clearly distinguishable. In short, there was no ownership or control (in the usual sense of those terms) of "*two or more* organizations, trades or businesses." (Emphasis added.)

Respondent does not seriously contest this conclusion. Rather, he argues that the requirements of section 482 are met because Forman's and McCurdy's had a common interest as far as their department store businesses were concerned which dictated that they act in concert with respect to Midtown. In urging this expansive interpretation of section 482, respondent recognizes that our holding in *Lake Erie & Pittsburgh Railroad Co.*, 5 T. C. 558 (1945), is directly contrary to his position. He urges us to overrule our prior decision and articulates on brief the analysis set forth in Rev. Rul. 65-142, 1965-1 C B. 223. In essence, this analysis is premised on the assertion that, in organizing

and operating Midtown, Forman's and McCurdy's should be considered as acting as a partnership and that there is, therefore, the requisite control of two entities, namely, the partnership and Midtown.

We have carefully reexamined our decision in *Lake Erie & Pittsburg Railway Co., supra,* and have concluded that it should be reaffirmed. The clear language of section 482 requires that there be *two* business entities with respect to which direct or indirect control by the same interests can be found. If we look at Midtown and Forman's or Midtown and McCurdy's, no such control existed. To import a *common objective test* into section 482, and thereby create a theoretical partnership between Forman's and McCurdy's, would require an unwarranted elasticized reading of the statutory language. Perhaps the absence of an obligation to pay interest on the loans produced a distortion of income as between Midtown and petitioners, but we find nothing in the legislative history which would justify the interpretation of the phrase "same interests" urged by respondent. Congress clearly had in mind a finding of ownership or control of two or more businesses by the same interests. See H. Rept. No. 2, 70th Cong., 1st Sess., pp. 16-17 (1927).[4] See also *Fred J. Sperapani,* 42 T. C. 308, 336, n. 6.

The hard fact is that Congress did not design section 482 to cover every potential distortion of income and deduction. To refer to McCurdy's shareholders and Forman's shareholders as "the same interests" would be a distortion, not of income, but of words. We are reinforced in our

[4] In enacting the 1954 Code, Congress explicitly stated it was making no substantive changes in section 482. See H. Rept. No. 1337, 83d Cong., 2d Sess., p. A165 (1954); S. Rept. No. 1622, 83d Cong., 2d Sess., p. 310 (1954).

conclusion by the fact that respondent acquiesced in our decision in *Lake Erie & Pittsburgh Railway Co., supra,* for twenty years. See 1945 C. B. 5; acquiescence withdrawn 1965-1 C. B. 5; Rev. Rul. 65-142, *supra.* Such long-standing administrative interpretation of statutory language may properly be taken into account. See *Hanover Bank v. Commissioner,* 369 U. S. 672, 686 (1962).

In view of our conclusion that the requisite control under section 482 did not exist, we do not decide whether this case would fall within the ambit of those decisions dealing with the question of the extent to which that section authorizes the allocation of income where no income is realized. See, *e.g., Smith-Bridgman & Co.,* 16 T. C. 287, 293 (1951). Nor need we consider the impact on section 482 of the specific provisions of section 483 dealing with imputed interest in certain situations. Compare also *J. Simpson Dean,* 35 T. C. 1083, 1087-1090 (1961).

Deductibility of Kiosk Prevention Payments

During each of the years in question, each petitioner paid Midtown $75,000 to keep kiosks off the North Mall and deducted the payments as ordinary and necessary business expenses. Respondent has disallowed the deductions.

Whether or not a payment constitutes an ordinary and necessary business expense constitutes primarily a question of fact. *Commissioner v. Heininger,* 320 U. S. 467, 475 (1943). See *Welch v. Helvering,* 290 U. S. 111, 115 (1933). Clearly, there is no automatic barrier to resolving that question in favor of a taxpayer even though the payor and payee are in a corporation-shareholders relationship. Compare *Ray's Clothes, Inc.,* 22 T. C. 1332

(1954). But where such a relationship exists, the payment should be subjected to close scrutiny to ensure that it is indeed what it purports to be. *E. g., Darco Realty Corporation v. Commissioner,* 301 F. 2d 190 (C. A. 2, 1962).

A pair of escalators and a causeway divided the shopping mall of Midtown Plaza into two unequal parts. The South Mall, the smaller of the two, had kiosks in it, tenanted by various commercial enterprises. The North Mall, which had petitioners' department stores along two of its sides, was kept clear of kiosks so that it could be used for non-commercial events. In effect, the North Mall functioned as a sort of community center. The various events held there drew people to Midtown Plaza who would not otherwise come. This extra traffic was of value to Midtown, to petitioners' department stores, and to all the commercial tenants of Midtown Plaza. Even more important is the quite considerable publicity generated by these events; this publicity served as a very effective form of institutional advertising.

Petitioners posit their assertion of deductibility on the ground that the payments served an advertising function, since they made possible the use of the North Mall for promotional events from which they directly benefited. They further seek to support their claim by arguing that they, in effect, rented the North Mall from Midtown and that, since $150,000 constituted a reasonable rental, commensurate with what an independent lessee would pay, it follows that that amount was paid exclusively for the use of the Mall and is therefore deductible. Compare *Polak's Frutal Works, Inc. v. United States,* 176 F. Supp. 521 (S. D. N. Y. 1959), affd. 281 F. 2d 261 (C. A. 2, 1960). We have no quarrel with petitioners' arguments as far as they go.

The difficulty is that they are not determinative of the question before us.

Use of the North Mall as a sort of community center doubtless benefited the petitioners, but equally beyond doubt is the benefit to Midtown Plaza as a whole. Midtown stood to benefit immediately to the extent that it would share in the increased business through percentage leases. And beyond this immediate benefit, the attractiveness of Midtown Plaza to business tenants was increased, thereby enhancing the ability of Midtown to obtain higher rentals in the future. These factors made it in the interest of Midtown to keep the North Mall free of kiosks. Concededly, landlords of shopping centers may normally want to rent out kiosks in order to obtain additional rentals. But Midtown was not faced with a simple choice between kiosks and no kiosks; it had to choose between kiosks and an extremely effective form of institutional advertising. In short, Midtown was faced with a choice as to what was in its own best independent interests. In our opinion, as our findings of fact show, it made that choice no later than April 10, 1962, the date on which Midtown Plaza opened and long before the contractual obligation to pay the $150,000 was undertaken by petitioners.

As we see it, the test is whether the arrangements calling for the payment of the $150,000 were in fact what they purported to be, namely, an annual expenditure for a current benefit to petitioners which Midtown had to be induced to confer. Clearly, the mere fact that petitioners were legally bound to make the payment is not determinative. See, *e.g.*, *Atlantic Monthly Co.*, 5 T. C. 1025, 1032 (1945). The question is: should petitioners be allowed a deduction as an ordinary and necessary business expense for recur-

ring payments for a promise by the payee not to undertake an activity which it had already decided not to undertake in its own independent interests? While we have found no decision which furnishes us with direct guidance, we conclude that the question should be answered in the negative. *Cf. Swed Distributing Company v. Commissioner*, 323 F. 2d 480 (C. A. 5, 1963), affirming a Memorandum Opinion of this Court on remand from 272 F. 2d 330 (C. A. 5, 1959), which, in turn, had reversed 31 T. C. 84 (1958); *Ingle Coal Corporation v. Commissioner*, 174 F. 2d 569 (C. A. 7, 1949), affirming 10 T. C. 1199 (1948); *Ray's Clothes, Inc., supra; Granberg Equipment, Inc.*, 11 T. C. 704 (1948).[5]

Our conclusion that the arrangements were not what they purport to be is further reinforced by several additional elements present herein:

(1) The fact that petitioners' payments to Midtown were equal is highly suggestive. Petitioners' sales volumes and income differed markedly. The effect upon the revenue of their department stores of the North Mall activities would almost certainly be different. If the decision to keep kiosks off the North Mall had been made in connection with the department store businesses of petitioners, it would seem that the petitioner who could expect to reap a lesser benefit from the advertising would have demanded that payment be proportional to its expected benefit. Moreover, we note that none of Midtown's tenants were asked to make such payments, although they benefited from the promotional events. Finally, the original agreement between petitioners required that their investment be equal. Thus, the equality of payments suggests that they were intended as capital contributions.

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[5] Compare also *Max J. Epstein*, T. C. Memo. 1964-192.

(2) There were good reasons for artificially inflating Midtown's income at the expense of the department store businesses. Midtown needed cash; petitioners therefore had to make capital contributions or loans to Midtown. Petitioners had substantial taxable income against which deductions could be used, Midtown had substantial tax losses to soak up increases in income, and Chiarella's bonus would be increased by increased rental income. To the extent that a capital contribution could be disguised as income to Midtown and business expense to the petitioners, everybody benefited and no one was hurt significantly. While tax avoidance may be a permissible objective where the substance and form of the transaction coincide, the presence of a pattern of tax benefits certainly constitutes a yellow caution signal on our road to decision. *Cf. George L. Schultz*, 50 T. C. 688, 694 (1968), affirmed *per curiam* 420 F. 2d 490 (C. A. 3, 1970).

We again emphasize that we are not dealing with a situation where the payment in question is for a benefit conferred which the payor was concerned it might lose through bona fide action action by the payee. Under such circumstances, the measurement of the value of the payments against the benefit conferred in order to support the contention of a quasi rental,[6] or the justification of the payments as an advertising expenditure, or the possibility of interference by the kiosks with the visibility of petitioners' store windows, or whether the petitioners were under obligation to Chiarella to maximize the income of Midtown in order to enhance his bonus would have been highly relevant.

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[6] In this connection, we note that, under the agreement of November 6, 1964, Midtown was to "retain complete control, direction and management" of the North Mall. And when charges were made for the use of North Mall space, Midtown, not petitioners, received the money.

But in the posture of this particular case, those considerations are totally beside the point.

We conclude that the payments of $75,000 by each of the petitioners to Midtown were disguised capital contributions and therefore not deductible expenses.

In order to reflect certain adjustments made in the notices of deficiency and not contested in the petitions, as well as our resolution of the first issue, *Decisions will be entered under Rule 50.*

Reviewed by the Court.

III. Opinion of the Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Nos. 768, 769, 770, 771—September Term, 1970.
(Argued June 1, 1971 Decided January 10, 1972.)
Docket Nos. 35434, 35839, 71-1026, 71-1027

B. FORMAN COMPANY, INC.,
Petitioner-Appellee,
against
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

McCURDY & COMPANY, INC.,
Petitioner-Appellee,
against
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

B. FORMAN COMPANY, INC.,
Petitioner-Appellant,
against
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

McCURDY & COMPANY, INC.,
Petitioner-Appellant,
against
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before: Clark, *Associate Justice,** Smith, *Circuit Judge,* Zavatt, *District Judge.***

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* Retired Associate Justice of the Supreme Court, sitting by designation.

** Senior District Judge for the Eastern District of New York, sitting by designation.

Cross-appeals from a decision of the Tax Court, Tannenwald, *Judge,* 54 T. C. 913 (1970), holding that (1) § 482 of the Internal Revenue Code of 1954 did not authorize the Commissioner to allocate to taxpayers interest income attributable to interest free loans made by taxpayers to Midtown and (2) that annual payments made by taxpayers to Midtown were not ordinary and necessary business expenses deductible under § 162 of the Internal Revenue Code of 1954.

Reversed as to the first holding, affirmed as to the second holding.

Ellsworth A. VanGraafeiland and Peter L. Faber (Wiser, Shaw, Freeman, VanGraafeiland, Harter & Secrest, Rochester, New York, Richard B. Secrest and William M. Colby, of counsel), *for Taxpayers.*

Stephen Schwarz, Attorney, Tax Division (Johnnie M. Walters, Assistant Attorney General, Meyer Rothwacks and Harry Baum, Attorneys, Tax Division, Department of Justice, Washington, D. C., of counsel), *for the Commissioner.*

ZAVATT, *D. J.:*

These are cross-appeals from a decision of the Tax Court 54 T. C. 913 (1970), holding (1) that 26 U. S. C. § 482 (the Internal Revenue Code of 1954, hereinafter the "Code") did not authorize the Commissioner to allocate to B. Forman Co., Inc. (Forman) and McCurdy & Co., Inc. (McCurdy) (both referred to herein as taxpayers) interest income attributable to interest free loans made by the taxpayers to Midtown Holdings Corp. (Midtown), because of the absence of the requisite § 482 control of Midtown by the taxpayers; and (2) that annual payments of $75,000.00 each made by the taxpayers to Midtown were not ordinary and necessary business expenses deductible under 26 U.

S. C. § 162. The Commissioner appeals from the first of these holdings; the taxpayers appeal from the second. We reverse the decision of the Tax Court as to the first and affirm as to the second of these holdings.

These consolidated cases involve the corporate income tax liability of Forman and of McCurdy for the fiscal years 1965, 1966 and 1967. Having disallowed the annual payments of $75,000.00 each year by the taxpayers to Midtown and having allocated as income to each taxpayer interest at the rate of 5% per annum on a $1,000,000.00 loan made by each taxpayer to Midtown prior to the fiscal years in question, the Commissioner assessed tax deficiencies against each taxpayer (now in dispute) as follows:

	Forman	*McCurdy*
1965	$ 62,425.55	$ 59,181.99
1966	58,775.14	59,643.92
1967	59,692.00	62,343.56
Totals	$180,892.69	$181,169.47

Following receipt of the Commissioner's notices of these deficiencies and on January 31, 1969, each taxpayer filed a petition with the Tax Court for a review of the respective tax deficiency determinations of the Commissioner, both of which petitions were consolidated.

For several years prior to and as of the date of the incorporation of Midtown, McCurdy (a New York corporation since 1901) operated a retail general department store at 285 Main Street East, Rochester, New York and Forman (a New York corporation since 1912) operated a retail department store, specializing in men's and women's apparel, at 46 Clinton Avenue South, Rochester, New York. All of the stock of McCurdy was owned by or in behalf of members of the McCurdy family. All of the stock of For-

man was owned by or in behalf of members of the Forman family. McCurdy and Forman had no common shareholders, directors or officers. Both corporations were competitors.

In an effort to stem declining incomes, McCurdy and Forman caused Midtown to be formed in 1958. On March 23, 1959 they entered into an agreement with reference to their participation in the building and development of a midtown shopping center in Rochester which would adjoin the rear entrances to their respective stores. By that time the Board of Directors and officers of Midtown consisted of the following:

	Relationship to McCurdy and Forman
Gilbert J. C. McCurdy (President and Chairman of Board of Directors of Midtown)	—Chairman of the Board of Directors and President of McCurdy
Gordon W. McCurdy (Secretary and a Director of Midtown)	—Vice-Chairman of the Board of Directors and Senior Vice-President of McCurdy
Maurice R. Forman (Vice-President and a Director of Midtown)	—Chairman of the Board of Directors and President of Forman
Fred Forman (Treasurer and a Director of Midtown)	—Member of the Board of Directors and Senior Vice-President of Forman
Lynn Johnston (Vice-President and General Manager of Midtown)	

It would appear from that agreement that when, in 1958, McCurdy and Forman decided to form Midtown and erect a shopping center in downtown Rochester, they each entered into lease agreements (with options to purchase) with the owners of the property on which they contemplated the construction of the shopping center. These properties are described in the appendices to the agreement of March 23, 1959. In and by that agreement McCurdy and Forman agreed to assign and transfer to Midtown their respective interests in these leases and options and to convey title to any such property already vested.

McCurdy and Forman had already acquired 50% each of the issued and outstanding shares of Midtown. In exchange for the real estate interests they were to assign and convey to Midtown, each of them was to receive an additional 810 common, no par value shares of Midtown, thus continuing their equal stock ownership in Midtown. If, prior to January 1, 1965, the Board of Directors of Midtown should determine, by resolution, that additional funds were necessary or advisable, McCurdy and Forman agreed to purchase additional shares of Midtown "so that their aggregate holding shall be One Million Dollars ($1,000,000) each, at any time, and from time to time . . ." In addition, each party to this agreement agreed to loan to Midtown additional amounts

> "so that their aggregate loans to Midtown shall be One Million Dollars ($1,000,000) each, at any time and from time to time, if, prior to January 1, 1965, the Board of Directors of Midtown, by resolution, shall determine that such additional funds in the form of borrowing are necessary or advisable. Loans shall be made equally by the parties.
>
> Such loans shall be represented by notes, or other evidence of indebtedness, of Midtown, the essential features of which shall be as follows:

(A) The notes shall pay interest at the rate of five (5) percent per annum, payable semi-annually on the first day of January and July in each year.

(B) The notes shall be due and payable thirty (30) years after issuance.

(C) Midtown shall have the right to prepay the notes in whole or in part on any interest paying date prior to maturity upon the payment of the principal amount thereof and accrued interest.

(D) The notes may be unsecured but shall not be subordinated to the claims of any other unsecured creditor of Midtown.

(E) The notes shall be part of a series, and there shall be no preference between the parties hereto as to payment of the notes of a series."

This agreement also provided for the control of Midtown by McCurdy and Forman by requiring each party thereto to vote its respective Midtown stock so as to provide for a Board of Directors consisting of three Directors designated by the Board of Directors of McCurdy and three Directors designated by the Board of Directors of Forman. At the request of either McCurdy or Forman, each party to the agreement undertook to vote its Midtown stock for a seventh Director. In the event they were unable to agree upon the seventh Director, McCurdy and Forman were to designate their respective representatives who would designate the seventh Director to be elected "by the parties hereto . . ." In the event that these representatives were unable to agree upon a seventh Director, a Justice of the Appellate Division of the Supreme Court, Fourth Judicial Department, was to act with the two representatives and the seventh Director of Midtown was then to be designated by majority vote of the Justice and the two representatives of the parties.

The agreement also limited the right of the parties to dispose of their Midtown stock to detailed conditions set forth therein.

Although the agreement provided for the designation of three Midtown Directors each by the parties, there were only four. During all of the relevant times the officers and directors of Midtown were:

Vice President and Director	Gilbert J. C. McCurdy
Secretary and Director	Maurice R. Forman
Treasurer and Director	Gordon W. McCurdy
President and Director	Fred Forman (until his death)
	Robert Aex (after Fred Forman's death)
	Aex represented Forman's interests
Vice President and General Manager	Lynn Johnston (to April 1, 1963)
	Angelo Chiarella (from May 27, 1963 on)

The shopping center, completed and opened for business in 1962, consisted of an eighteen story building, a four story building (adjoining the Mall), and a three level underground parking garage. Each taxpayer initially invested a total of $1,000,000.00 in return for Midtown stock. The original estimated cost of the shopping center was $8,000,000.00. The actual cost exceeded $18,000,000.00.

Construction commenced in 1959. The record does not reveal all of the financing for this project. It does show that Midtown entered into a building loan agreement with

Lincoln Rochester Trust Company (Lincoln), dated April 18, 1961, providing for advances not to exceed $11,000,000.00 to be evidenced by notes bearing interest at the rate of six percent per year, secured by the "personal guarantees of certain officers of the Company and others" and "a conditional assignment of rents of the premises." During 1958 and 1959, McCurdy and Forman made several loans to Midtown, the amounts of which are not revealed by the record or stated in the stipulation of facts in the proceeding before the Tax Court. It was so stipulated, however, that, on May 1, 1959, the several loans were consolidated into single obligations of Midtown of $662,500.00 each to McCurdy and Forman, represented by thirty-year notes of Midtown, each bearing interest at the rate of five percent per annum. (These notes were satisfied in July of 1959, without interest, from the proceeds of a $2,700,000.00 line of credit established by Midtown with Lincoln. The fact that McCurdy and Forman each waived interest on these notes is not involved in the instant case.)

Allocation of Interest Income under 26 U. S. C. § 482

The issue as to allocation of income to McCurdy and Forman for the fiscal years 1965, 1966 and 1967 stems from loans of $1,000,000.00 each by the taxpayers to Midtown on September 9, 1960, each represented by a three-year note of Midtown to each taxpayer, bearing interest at the rate of three and one-half percent per annum. These notes were cancelled in April 1961, without payment of any principal or interest. In lieu thereof, they were replaced by notes of $1,000,000.00 each, predated September 9, 1960 and bearing no interest. On their due date, September 9, 1963, they were replaced by three-year notes in the same principal amounts, bearing no interest—without any payment of

principal or interest having been made thereon. These notes, dated September 9, 1963, were replaced on September 9, 1966 by three-year notes in the same amounts, bearing no interest, without any payment of principal or interest having been paid thereon. No payments of principal or interest have ever been made on the notes dated, respectively, September 9, 1960, September 9, 1963 and September 9, 1966. The issue as to the Commissioner's allocation of income to McCurdy and Forman relates to the notes dated September 9, 1963 and September 9, 1966.

The Commissioner imputed interest income at the rate of five percent per annum on those $1,000,000.00 loans by McCurdy and Forman to Midtown ($50,000.00 of income to each taxpayer during their fiscal years 1965, 1966 and 1967), pursuant to 26 U. S. C. § 482, which provides:

> "482. Allocation of income and deductions among taxpayers
>
> In any case of two or more organizations, trades, or businesses (whether or not incorporated, whether or not organized in the United States, and whether or not affiliated) owned or controlled directly or indirectly by the same interests, the Secretary or his delegate may distribute, apportion, or allocate gross income, deductions, credits, or allowances between or among such organizations, trades, or businesses, if he determines that such distribution, apportionment, or allocation is necessary in order to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses."

The Tax Court reversed the Commissioner's determination, holding in effect that Midtown was not "controlled directly or indirectly" by either McCurdy or by Forman and that McCurdy and Forman may not be regarded as a single entity controlling Midtown.

> "The clear language of section 482 requires that there be *two* business entities with respect to which direct or

> indirect control by the same interests can be found. If we look at Midtown and Forman's or Midtown and McCurdy's, no such control existed. To import a *common objective test* into section 482, and thereby create a theoretical partnership between Forman's and McCurdy's, would require an unwarranted elasticized reading of the statutory language."
>
> 54 T. C. at 923.

Legislative History

26 U. S. C. § 482 derives from section 45 of the Internal Revenue Code of 1928. The House report with reference to section 45 of the 1928 Code explained that its purpose was to allow the Commissioner to

> "distribute the income or deductions between or among [commonly controlled taxpayers] . . ., as may be necessary in order to prevent evasion (by the shifting of profits, the making of fictitious sales, and other methods frequently adopted for the purpose of 'milking'), and in order clearly to reflect their true tax liability."
>
> H. Rep. No. 2, 70th Cong., 1st Sess., pp. 16-17 (1939-1 Cum. Bull. Part 2 384, 395).

Provisions somewhat similar to those in section 45 were contained in prior Revenue Acts. Section 240 (d) of the Revenue Act of 1924, 43 Stat. 288, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 45, authorized the Commissioner to consolidate the accounts of two or more related trades or businesses owned or controlled by the same interests. It did not authorize him to distribute, apportion, or allocate, as in section 482. Section 240(f) of the Revenue Act of 1926, 44 Stat. 46, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 191 contained the very same language as in section 240(d) of the Revenue Act of 1924. Section 45 of the Revenue Act of 1928, 45 Stat. 806, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 364, effected a change.

The sections of the prior acts were under the caption "Consolidated Returns of Corporations." The caption of section 45 of the Revenue Act of 1928 was "Allocation of Income and Deductions." Its language is substantially identical to that in present section 482. The same is true of section 45 of the Revenue Act of 1932, 47 Stat. 186, Internal Revenue Acts 1924 to Date, 26 U. S. C. A. p. 498; section 45 of the Revenue Act of 1934, 48 Stat. 695, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 680; section 45 of the Revenue Act of 1936, 49 Stat. 1667, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 840; section 45 of the Revenue Act of 1938, 52 Stat. 474, Internal Revenue Acts of 1924 to Date, 26 U. S. C. A. p. 1028 and section 45 of the Internal Revenue Code of 1939, 26 U. S. C. A. § 45; the Internal Revenue Code of 1954, section 482. The Revenue Act of 1928 eliminated the right of affiliated corporations to file consolidated returns and the right of the Commissioner to consolidate the accounts of two or more related trades or businesses controlled by the same interests. In lieu thereof section 45 was inserted which "broadened considerably" former section 240(f) of the 1926 Act "in order to afford adequate protection to the Government made necessary by the elimination of the consolidated return provisions of the 1926 Act." *National Securities Corp. v. Commissioner*, 137 F. 2d 600, 602 (3d Cir.), *cert. denied*, 320 U. S. 794, 64 S. Ct. 262, 88 L. Ed. 479 (1943); H. R. 2, 70th Cong., 1st Sess.

Lake Erie

The decision of the Tax Court in *Lake Erie & Pittsburg Railway Co. v. Commissioner*, 5 T. C. 558 (1945), is the only judicial determination based on facts substantially similar

to those in the instant case. The Tax Court reaffirmed that decision in the instant case. In *Lake Erie,* the New York Central Railroad and the Pennsylvania Railroad (two independent competing corporations, having no common stockholders, officers or directors), formed a third corporation, the Lake Erie & Pittsburg Railway Co. (Lake Erie), for the purpose of acquiring, building, maintaining, leasing and operating a railroad between Lorain and Youngstown, Ohio. New York Central and Pennsylvania railroads were the sole, equal stockholders of Lake Erie. They used the facilities of Lake Erie for which use they originally paid rent pursuant to a 1908 agreement and Lake Erie paid dividends to these two stockholders. This agreement was modified in 1939 so as to release the two railroads from their obligation to pay rent to Lake Erie and release Lake Erie of its obligation to pay them (as stockholders) dividends. The Commissioner allocated to Lake Erie as income to it, during 1937, 1938, 1939 and 1940, from the gross income of the railroads an amount equal to the rent which the railroads were originally obligated to pay to Lake Erie. Lake Erie had reported no taxable net income for each of these years. The Tax Court reversed the determination of the Commissioner on the ground that he was without authority to make the questioned allocation pursuant to section 45 of the Internal Revenue Code of 1939:

> "The stockholders of the New York Central are not the 'same interests' as the stockholders of Pennsylvania and neither the New York Central nor the Pennsylvania has control of the petitioner. Together they do have. But that amounts to saying nothing more than that the stockholders of a corporation control it. We do not think that it can be said where two or more corporations owned by different sets of stockholders control another corporation such other corporation is controlled by the same interests."

5 T. C. at 564-565.

The Commissioner acquiesced in the decision of the Tax Court in Lake Erie. C. B. 1945, 5. In 1965, however, the Commissioner withdrew the prior acquiescence and substituted nonacquiescence. Rev. Rul. 65-142, 1965-1 Cum. Bull. 223.

The declared purpose of section 482 is "to prevent evasion of taxes or clearly to reflect the income of . . . organizations . . . owned or controlled directly or indirectly by the same interests." This legislative purpose is reflected in the Treasury Regulations where it is stated that:

> "The purpose of section 482 is to place a controlled taxpayer on a tax parity with an uncontrolled taxpayer, by determining, according to the standard of an uncontrolled taxpayer, the true taxable income from the property and business of a controlled taxpayer . . . The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer . . . Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes."
>
> Treas. Reg. § 1.482(b)(c)

The courts recognize the congressional purpose of section 482 to prevent evasion or avoidance of otherwise payable taxes by means of shifting profits or by other financial devices and have given broad scope to the Commissioner's discretion in making reallocations of income, where the exercise of this power is not unreasonable or arbitrary. *W. Braun Co. v. C. I. R.*, 396 F. 2d 264, 266 (2d Cir. 1968). Similar recognition was given to section 45 of the Revenue Act of 1928. *Central Cuba Sugar Co. v. Commissioner*, 198 F. 2d 214, 216 (2d Cir.), *cert. denied*, 344 U. S. 874, 73 S. Ct. 167 (1952). The courts have also construed this statute liberally in order to achieve the declared purpose

of Congress. In *Asiatic Petroleum Co. v. Commissioner*, 79 F. 2d 234 (2d Cir.), *cert. denied*, 296 U. S. 645, 56 S. Ct. 248, 80 L. Ed. 459 (1935), it was held that the phrase "evasion of taxes" in section 45 of the Revenue Act of 1928 "is broad enough to include the avoidance of the realization for taxation of such a profit through its transfer to another branch of the same business enterprise in a way which only changes its place in the business set up." 79 F. 2d at 236. The court also gave a broad meaning to the term "gross income" in section 45. It referred to the progress of section 45 of the Revenue Act of 1928 in support of its liberal interpretation of that statute. 79 F. 2d at 236. *See also, Advance Machinery Exchange v. Commissioner*, 196 F. 2d 1006 (2d Cir.), *cert. denied*, 344 U. S. 835, 73 S. Ct. 45 (1952).

Whether the Commissioner was correct in allocating to McCurdy and Forman interest on their respective loans of $1,000,000.00 each is essentially one of fact, and his decision must be affirmed if supported by substantial evidence. *Advance Machinery Exchange, supra*, at 1007. Where, as here however, the Tax Court has reversed the Commissioner, the decision of the Tax Court must be affirmed unless clearly erroneous. *Commissioner v. Duberstein*, 363 U. S. 278, 80 S. Ct. 1190 (1960); *Schley v. Commissioner*, 375 F. 2d 747 (2d Cir. 1967); *LaMont v. Commissioner*, 339 F. 2d 377 (2d Cir. 1964). In order to justify an allocating of income pursuant to section 482, the Commissioner must find that (1) there are two or more trades, businesses or organizations (2) owned or controlled by the same interests and (3) that it is necessary to allocate gross income, deductions, credits, or allowances among them in order to prevent evasion of taxes or in order to clearly reflect their income.

Treasury Regulations

Treasury regulations must be sustained unless unreasonable and plainly inconsistent with the revenue statutes. *Commissioner v. South Texas Lumber Co.*, 333 U. S. 496, 501, 68 S. Ct. 695, 698 (1948); *Sanford v. Commissioner*, 412 F. 2d 201, 202 (2d Cir.), *cert. denied*, 396 U. S. 841, 90 S. Ct. 104 (1969).

Organization

The terms "organization," "trade," "business" are broadly defined in Treas. Reg. § 1.482-1(a)(1) and (2). In *Borge v. Commissioner*, 405 F. 2d 673 (2d Cir. 1968), *cert. denied, sub nom., Danica Enterprises, Inc. v. Commissioner*, 395 U. S. 933, 89 S. Ct. 1994 (1969), this court found that an individual stockholder and his wholly owned corporation satisfied the two or more business prerequisite of section 482. Certainly, Midtown, McCurdy and Forman satisfy this prerequisite.

Control

No definition of "control" is contained in section 482. It has been opined that this omission was intentional in order to allow for flexibility of administration. Plumb and Kapp, *Reallocation of Income and Deductions Under Section 482*, 41 Taxes 808, 811 (1963).

Guidelines for determining control are contained in Treas. Reg. 1.482-1(a)(3):

> "The term 'controlled' includes any kind of control, direct or indirect, whether legally enforceable, and however exercisable or exercised. It is the reality of the control which is decisive, not its form or the mode of its exercise. A presumption of control arises if income or deductions have been arbitrarily shifted."

To the same effect see Treas. Regs. 39.45-1(a)(3) and annual Treasury regulations thereafter.

As to "same interests," there is no statutory definition and no Treasury regulations guidelines.

In order to find control, no percentage requirements are specified nor are any precise requirements necessary. The trend in the recent case law is to apply the realistic approach. *Borge v. Commissioner, supra; Hall v. Commissioner,* 32 T. C. 390 (1959), aff'd., 294 F. 2d 82 (5th Cir. 1961); *Grenada Industries, Inc. v. Commissioner,* 17 T. C. 231 (1951), *aff'd.*, 202 F. 2d 873 (5th Cir.), *cert. denied,* 346 U. S. 819, 74 S. Ct. 32 (1953). Despite the fact that these cases are all distinguishable on their facts, they lend support to the view that the Commissioner urges here.

In *Borge v. Commissioner, supra,* this Court held that an individual (the entertainer Victor Borge) and his wholly owned corporation, conducting a poultry business, were commonly controlled within the purview of § 482 and that the Commissioner was justified in allocating income from the corporation to Victor Borge, because the contract between him and his wholly owned corporation would never have been made between two unrelated parties dealing at arm's length.

In *Hall v. Commissioner, supra,* the taxpayer (Hall) conducted a business individually. Thereafter he formed a corporation and transferred nearly all of his shares of stock of that corporation to his son. The court upheld the allocation of income between Hall and the corporation under § 45 of the 1939 Code. It disregarded the issue of who actually owned the stock, holding that Hall, in fact, actively controlled the corporation, despite his contention that he had transferred ownership of the stock. The Tax

Court, in *Ach v. Commissioner*, 42 T. C. 114 (1964), *aff'd.*, 358 F. 2d 342 (6th Cir.), *cert. denied*, 385 U. S. 899, 87 S. Ct. 205 (1966), restated its view that it is not the record ownership of stock which determines control; that control is to be determined by ascertaining who, in fact, has control.

In *Grenada Industries, Inc. v. Commissioner, supra*, two corporations and two partnerships were owned by four families in identical 35%-35%-20%-10% proportions. In upholding an allocation of income among the four organizations, the court noted that it was immaterial that the record ownership of the stock and the partnership interests may not have been in the identical persons at the same time. Control was inferred from the actions of the parties.

If Midtown was the creature of only one of the taxpayers, and all of its stock were owned by that single parent, *i.e.*, if Midtown were a strange creature having a father but no mother, the most rigid, literal wooden interpretation of section 482 would bring Midtown within the ambit of that section. It is the contention of the taxpayers, however, that section 482 is not applicable because Midtown is the normal child of a father and a mother, the product of an earthy relationship between McCurdy and Forman, twentieth century parents exercising no control over their progeny.

Midtown is the creation of a union of McCurdy and Forman—not in holy matrimony but in a legitimate business enterprise. Their interests in the existence and career of Midtown and the interests of Midtown are identical.

To contend that these parents do not control their child is to fly in the face of reality. They have had complete control of Midtown from the day of conception (its incorporation) throughout the years relevant to this case.

Every act of Midtown has been dictated by papa and momma who, directly or indirectly, have financed its career and controlled its every move.

In apparent disregard of the reality of the circumstances, the Tax Court below looked only to the record ownership of Midtown. Ignored was reality of the control of Midtown. In withdrawing his acquiescence in *Lake Erie*, the Commissioner concluded that *Lake Erie* was inconsistent with the broad language of § 482 and the trend of cases discussed *supra*, and noted that *Lake Erie* ignored the reality of the control in that case.

The Commission is supported by the views of commentators.[1]

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[1] James O. Hewitt is of the view that the two railroads in *Lake Erie* acted in concert and controlled the Lake Erie Company.

> "It would seem that the court based its determination upon an unduly restricted interpretation of the phrase 'controlled directly or indirectly by the same interests.' The Tax Court could have found this section applicable by reasoning that although neither the New York Central nor the Pennsylvania Railroad alone had control of the taxpayer corporation, together they controlled the taxpayer by virtue of their agreement to manipulate the price charged for the use of taxpayer's facilities. Although the New York and Pennsylvania Railroads were normally competitors, in their joint use of taxpayer's railroad facilities they might be treated as partners. Transactions between a partnership and a related corporation have been held subject to the provisions of Section 482. [*Grenada, supra*] By agreeing to lower rentals to be paid to the taxpayer they were acting in concert, . . . the court may have held that there was an exercise of 'control directly or indirectly by the same interests'." Hewitt, *Section 482-Allocation of Income and Control among Related Taxpayers*, N.Y.U. 20th Inst. on Fed. Tax. 463, 472-73 (1962).

As to the opinion of the court in *Lake Erie* that common control was negated because the two parent corporations had separate and independent shareholders, Hewitt made the following comment in a subsequent article:

> "This seems to be fallacious reasoning. One can hardly maintain that the two railroads were competing with regard to the services

(Footnote continued on following page)

The loans by taxpayers to Midtown, without interest, affected the incomes of taxpayers and of Midtown. By not reporting interests on these loans, taxpayers reported lower earnings and, in turn, lower taxes. Midtown, in not paying interest, eliminated a business expense which would have further increased its yearly losses. Because of Midtown's unfavorable financial condition, it was encountering difficulty in the rental of stores, a matter of concern to McCurdy and Forman, the actual owners of Midtown. Midtown, McCurdy and Forman were loathe to show as further losses annual interest payments on $2,000,000.00 of loans at 5% *i.e.*, $100,000.00 per year, and the elimination of annual payments of $150,000.00 by McCurdy and Forman. Reference to these payments will be made *infra*. Mr. Chiarella, general manager of Midtown, testifying before the Tax Court as to these annual payments of $150,000.00, said that they definitely helped to narrow Midtown's deficit; that without these payments

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(Footnote continued from preceding page)

of the taxpayer since they were in concert manipulating the price charged for the taxpayer's facilities. . . . [I]t would seem difficult to apply on a mechanistic basis any percentage to determine if control exists. Control may be determined to be the power to direct operations of the company, or establish policy for the organization . . . so that any percentage application would be inconsistent with the definition of control." Hewitt, *Section 482-Allocation of Income and Deductions Before an Related Persons-Up to Date*, N.Y.U. 22d Inst. on Fed. Tax. 381, 384-85 (1964).

The authors of an article, *"Reallocation of Income and Deductions Under Section 482,"* in 41 Taxes 809, 812 (1963), commented on the decision in *Lake Erie* as follows:

> *"Lake Erie & Pittsburg Railway Co. v. Commissioner* held that control by the same interests did not exist since each parent was controlled by its own set of stockholders which was not the same as the combined set of stockholders who indirectly controlled the subsidiary. Yet, when they act in concert, for their mutual interest to cause the subsidiary to provide goods or services at other than arm's length prices, the reality of control exists to at least as great an extent as it did in the *Hall* case."

Midtown would have had to get that money from some place. Appendix p. 280a. This explanation is equally applicable to the waiver of interest on the loans aggregating $2,000,000.00.

Whether McCurdy and Forman are regarded as a partnership or joint venture, *de facto*, in forming Midtown, the conclusion is inescapable that they acted in concert in making loans without interest to a corporation, all of whose stock they owned and all of whose directors and officers were their alter egos. They were not competitors in their dealings with one another or with Midtown as to Midtown. Their interests in Midtown were identical. When the Commissioner withdrew his acquiescence in *Lake Erie*, he gave reality control as one of the reasons for doing so. "[T]he reality of control by the same interests is present no less than if they [the two parent railroads] had formed a partnership . . . to deal with the petitioner [Lake Erie Railway Company] or had formed another corporation to deal with petitioner." Rev. Rul. 64-142. We agree.

We find clearly erroneous the holding of the Tax Court that the requisite control of Midtown by the taxpapers was not present and find further that McCurdy and Forman had the same interests in Midtown.

Having found two businesses under common control, we reach the question as to whether the Commissioner properly allocated interest on the two loans of $1,000,000.00 each as income to the taxpayers.

"Transactions between one controlled taxpayer and another will be subjected to special scrutiny to ascertain whether the common control is being used to reduce, avoid, or escape taxes." Treas. Reg. 1.482-1(c). To same effect,

see *Local Finance Corporation v. Commissioner*, 407 F. 2d 629, 632 (7th Cir.), *cert. denied*, 396 U. S. 956, 90 S. Ct. 428 (1969). To justify the allocation as income to McCurdy and Forman of interest on their loans, it must be found that their waiver of interest "is other than it would have been had the taxpayer in the conduct of his affairs been an uncontrolled taxpayer dealing at arm's length with another controlled taxpayer." Treas. Reg. 1.482-1(c). *See also, Local Finance Corp. v. Commissioner, supra*, at 632; *Lilly and Co. v. United States*, 372 F. 2d 990, 1000 (Ct. Cl. 1967); *Oil Base, Inc. v. Commissioner*, 362 F. 2d 212, 214 (9th Cir.), *cert. denied*, 385 U. S. 928, 87 S. Ct. 287 (1966). "In determining the true taxable income of a controlled taxpayer, the district director is not restricted to the case of improper accounting, to the case of a fraudulent, colorable, or sham transaction, or to the case of a device designed to reduce or avoid tax by shifting or distorting income, deductions, credits, or allowances." Treas. Reg. 1.482-1(c).

Reallocation is necessary here in order to properly reflect the income of taxpayers and Midtown. Taxpayers have advanced an argument, supported by case law, that the Commissioner may not create income where none actually existed. In *Tennessee-Arkansas Gravel Co. v. Commissioner*, 112 F. 2d 508 (6th Cir. 1940), the court held that the Commissioner could not increase the income of a taxpayer whose property had been used by a related corporation without the payment of rent. The court concluded that, since no rent was called for, none could be created. In *Smith-Bridgman & Co. v. Commissioner*, 16 T. C. 287 (1951), the Commissioner had added interest to the taxable income of Smith-Bridgman & Co., as allegedly constituting interest which should have been charged by it on non-interest bearing loans to its parent corporation, Continental Department

Stores (Continental). Taxpayer did not report as income any interest on these loans. The Tax Court, in overruling the Commissioner, who had allocated interest to Smith-Bridgman, refused to authorize the creation of income where no income was realized. This decision was thought to rest on the fact that the Commissioner had added interest to taxpayer, but had failed to make an adjustment to the income of Continental. However, the rationale of *Smith-Bridgman* was clarified in *Huber Homes, Inc. v. Commissioner*, 55 T. C. 598 (1971), where it was held that the failure to make the adjustment was only a possible supporting factor, not a controlling factor. *Smith* was reaffirmed in *PPG, Industries, Inc. v. Commissioner*, 55 T. C. 928 (1970), where the Tax Court held that § 482 did not authorize the Commissioner to impute interest on non-interest bearing loans where in fact no interest was created.

Several cases have held that one related party is not required to charge another related party interest on a loan; that the lender is not to be taxed on interest, with respect to a loan, where it was not intended that interest be collected. In *Combs Lumber Co. v. Commissioner*, 41 B. T. A. 339 (1940), it was the practice of the corporation to lend money to its stockholders without interest. The Board of Tax Appeals ruled that, under the circumstances, no liability for interest was created and, thus, the Commissioner could not impute interest to the lender. In *Society Brand Clothes, Inc. v. Commissioner*, 18 T. C. 304 (1952), a corporation held a ten year note of its wholly owned subsidiary. The note provided for the payment of interest, but it was executed with the understanding that no interest would be charged until some date in the future. The Tax Court held that the corporation was not required to report any interest not received by it. A similar result was reached in

Atchison, Topeka & Santa Fe Railway Co. v. Commissioner, 36 T. C. 584 (1961).

To the extent that the above cases cited by taxpayers may be read as holding that no interest can be allocated under § 482 under the facts of this case, they are not in accord with either economic reality, or with the declared purpose of section 482. They seriously impair the usefulness of § 482. Those cases may be correct from a pure accounting standpoint. Nevertheless, interest income may be added to taxpayers' incomes, as long as a correlative adjustment is made to Midtown, for then the true taxable income of all involved will be properly reflected. Treas. Reg. § 1.482-1(a)(6) provides:

> "The term 'true taxable income' means . . . the taxable income . . . which would have resulted to the controlled taxpayer, had it in the conduct of its affairs . . . dealt with the other member . . . at arm's length. It does not mean the income . . . or allowances, resulting to the controlled taxpayer by reason of the particular . . . transaction . . . the controlled taxpayer . . . chose to make (even though such . . . transaction . . . may be legally binding upon the parties thereto)."

Treas. Reg. § 1.482-2(a) provides:

> "Where one member of a group of controlled entities makes a loan or advance directly or indirectly to, or otherwise becomes a creditor of, another member of such group, and charges no interest . . . the district director may make appropriate allocations to reflect an arm's length interest rate for the use of such loan . . .."

These regulations must prevail, for they are entirely consistent with the scope and purpose of § 482. The instant loans without interest are obviously not at arm's length, since no unrelated parties would loan such large sums without interest. The allocation of the interest income to

taxpayers was necessary in order to properly reflect their taxable incomes.

Taxpayers contend that the $1,000,000.00 loans were not in fact loans; that they were contributions to capital. This argument is completely without merit. The terms of the loans plus the terms of the 1959 Agreement, specifying the creation of $1,000,000,00 loans, leave no doubt that the parties intended to and did treat these transactions as loans. Further, there is no evidence in the record that the taxpayers received additional stock of Midtown for these alleged capital contributions.

Our remaining concern is with whether the allocation of interest at 5 percent was proper. The Tax Court in its decision did not reach this issue. A remand is not necessary because, under both the regulations and the circumstances of this case, the 5% interest charge was eminently reasonable. Treas. Reg. 1.482-2(a)(2) provides the standard for determining the appropriate interest to be charged:

> "For the purposes of this paragraph, the arm's length interest rate shall be the rate of interest which . . . would have been charged at the time the indebtedness arose, in independent transactions with or between unrelated parties under similar circumstances. . . . If the creditor was not regularly engaged in the business of making loans or advances of the same general type as the loan or advance in question to unrelated parties, the arm's length rate for purposes of this paragraph shall be—
>
> (i) The rate of interest actually charged of at least 4 but not in excess of 6 percent per annum simple interest,
>
> (ii) 5 percent per annum simple interest if no interest was charged or if the rate of interest charged was

less than 4, or in excess of 6 per cent per annum simple interest,

unless the taxpayer establishes a more appropriate rate . . .."

Midtown's balance sheets reveal that it paid interest on various loans, ranging from 4 and ½% to 6% per annum. (See for example pp. 97, 106, 109, 112, 133 and 166 of the Exhibit file.) Midtown had outstanding loans from Lincoln Rochester Trust Co. payable at 5 and ½% interest; from Central Trust Co. payable at 5 and ½% per annum and from D. Raffelson payable at 5% per annum. Considering the rate of interest Midtown paid on its arm's length loans and the Treasury Regulations, 5% is an appropriate rate of interest.

This Court finds that the reversal by the Tax Court of the determination of the Commissioner allocating to the taxpayers interest income at 5% on their respective loans of $1,000,000.00 to Midtown is clearly erroneous.

The annual payments of $75,000.00 each by McCurdy and Forman to Midtown

The initial plans for the enclosed mall shopping center (Midtown Plaza) contemplated kiosks in the southern portion of the mall (South Mall) and the northern portion thereof (North Mall). Midtown constructed and rented four kiosks in the South Mall. No more than three of these kiosks were rented and occupied at one time. No kiosks were erected in the North Mall, although "utility pits" for future kiosks in the North Mall were completed so that, if kiosks were erected there in the future, they could be readily connected to utilities. The Tax Court found that, at some time after the original plan to erect kiosks in the North Mall, Midtown decided not to do so but, rather, to

preserve the North Mall space (180 feet by 110 feet with twice the square footage of the South Mall) for non-commercial events. The record amply supports this finding. The North Mall, with its fountain and permanent exhibit known as the "Clock of Nations," was a focal point of Midtown Plaza, used for numerous non-commercial activities which attracted considerable publicity.

At the hearing before the Tax Court, Angelo Chiarella (Chiarella), employed by Midtown as its General Manager, pursuant to a written contract of employment, testified that it was his suggestion that kiosks be erected in the North Mall. His contract of employment provided that he was to serve as General Manager of Midtown "under the general supervision and direction of the President of the Corporation and with such duties as may be reasonably assigned to him by the President of the Corporation and by its Board of Directors . . ." Entrance to the stores of both taxpayers was available from this mall and display windows of each store were visible from that mall. After Chiarella had discussed his idea that (kiosks be so erected and rented) with Gilbert J. C. McCurdy (President and Chairman of the Board of Directors of Midtown and also President and Chairman of the Board of Directors of McCurdy) and with Maurice R. Forman (Vice-President and a Director of Midtown and also President and Chairman of the Board of Directors of Forman), Chiarella wrote identical letters to McCurdy and Forman, each dated May 7, 1964, which he signed as a Vice-President of Midtown. The gist of these letters was that Midtown was losing rental income by complying with the requests of McCurdy and Forman that no kiosks be erected in the North Mall; that McCurdy and Forman derived numerous benefits from the absence of kiosks in the North Mall; that Midtown could erect and

rent ten kiosks in the North Mall and thereby increase its annual rental income by $150,000.00; that in lieu thereof, McCurdy and Forman should each pay $75,000.00 per annum to Midtown for its continued compliance with the requests of McCurdy and Forman that no kiosks be erected in the North Mall.

On October 27, 1964, Midtown (by Chiarella, Vice-President) made a written offer to Gilbert J. C. McCurdy, Chairman of the Board of McCurdy, and Maurice R. Forman, President of Forman, that Midtown would accede to the said wishes of McCurdy and Forman and would not conduct any promotional events or rent the North Mall for any events or displays that would be conducted in a manner to distract from the esthetic dignity of McCurdy and Forman, in consideration of the payment by each of them of the sum of $75,000.00 per year commencing February 1, 1964. Each taxpayer accepted this offer on November 6, 1964, McCurdy, by the Chairman of the Board; Forman, by its President. It would appear that there was a studied avoidance of any signature to this Midtown offer by any officer or director holding stock in Midtown. Nevertheless, it is obvious from the terms of his employment contract that he signed this Midtown offer pursuant to the direction of the President of Midtown and that the offer was made with the knowledge and/or subsequent consent of the Board of Directors of Midtown. In effect, of course, McCurdy and Forman (as owners of Midtown and of the taxpayer stores) were dealing with one another at less than an arm's length transaction. McCurdy and Forman had the power to prevent the erection of kiosks by Midtown (its controlled entity) in the North Mall.

McCurdy and Forman each paid $75,000.00 to Midtown during their fiscal years 1965, 1966 and 1967 or a total of

$225,000.00 each. They deducted these annual payments as ordinary and necessary business expenses paid during each taxable year in carrying on their respective businesses. 26 U. S. C. § 162(a). The taxpayers took the position that absence of kiosks in the North Mall was responsible for substantial benefits which "more than justified the expense involved"; that kiosks in the North Mall would have obstructed the visibility of their display windows; that they would have siphoned off "impulse shoppers"; would have created a "crass commercial atmosphere" inconsistent with their status as "quality" stores; that they would have taken up so much space that it would have been impossible for Midtown to hold the special events which were held in the mall, *e.g.*, charity balls, scientific exhibits, dinners, etc.; that the holding of such events was a form of advertising by Forman and McCurdy, which would have been prevented if the kiosks were erected; that they regarded these annual payments of $75,000.00 as rental payments, in the sense that these payments insured that the mall area surrounding their stores would not be used in a "detrimental manner." The taxpayers assert that, during the period from the opening of Midtown Plaza through the taxable years at issue, McCurdy's annual sales increased by 5.2 million dollars and Forman's sales increased by 40% and they attribute these increases to "the presence of Midtown Plaza and its Mall." Thus they took the position that these annual payments were deductible as ordinary and necessary business expenses.

The Commissioner disallowed these deductions. The Tax Court affirmed the determinations of the Commissioner. It found that these "Kiosk-Prevention Payments" were not ordinary and necessary business expenses, but, rather, "disguised capital contributions and therefore not deductible expenses," 54 T. C. at 926; that [a]t least by April 10, 1962,

when Midtown Plaza opened for business, Midtown had made a firm decision not to construct and rent kiosks on the North Mall and such decision continued in full force and effect during all the periods relevant herein," 54 T. C. at 921:

> "that the arrangements were not what they purport to be . . .
>
> (1) The fact that petitioner's payments to Midtown were equal is highly suggestive. Petitioners' sales volumes and income differed markedly. The effect upon the revenue of their department stores of the North Mall activities would almost certainly be different. If the decision to keep kiosks off the North Mall had been made in connection with the department store businesses of petitioners, it would seem that the petitioner who could expect to reap a lesser benefit from the advertising would have demanded that payment be proportional to its expected benefit. Moreover, we note that none of Midtown's tenants were asked to make such payments, although they benefited from the promotional events. Finally, the original agreement between petitioners required that their investment be equal. Thus, the equality of payments suggests that they were intended as capital contributions.
>
> (2) There were good reasons for artificially inflating Midtown's income at the expense of the department store businesses. Midtown needed cash; petitioners therefore had to make capital contributions or loans to Midtown. Petitioners had substantial taxable income against which deductions could be used, Midtown had substantial tax losses to soak up increases in income, and Chiarella's bonus would be increased by increased rental income. To the extent that a capital contribution could be disguised as income to Midtown and business expense to the petitioners, everybody benefited and no one was hurt significantly. While tax avoidance may be a permissible objective where the substance and form of the transaction coincide, the presence of a pattern of tax benefits certainly constitutes a yellow caution signal on our road to decision.

Cf. George L. Schultz, 50 T. C. 688, 694 (1968), affirmed *per curiam* 420 F. 2d 490 (C. A. 3, 1970).

We again emphasize that we are not dealing with a situation where the payment in question is for a benefit conferred which the payor was concerned it might lose through bona fide action by the payee."

The record fully warrants the Tax Court's conclusion that the annual payments made by the taxpayers to Midtown were not ordinary and necessary expenses deductible under 26 U. S. C. § 162. The determination of whether or not a payment constitutes an ordinary and necessary business expense is, in most instances, a question of fact. *Commissioner v. Duberstein*, 363 U. S. 278, 80 S. Ct. 1190 (1960); *Commissioner v. Heininger*, 320 U. S. 467, 64 S. Ct. 249 (1943); *Chenango Textile Corp. v. Commissioner*, 148 F. 2d 296 (2d Cir. 1945). The Tax Court's findings must be sustained unless clearly erroneous. *Commissioner v. Duberstein, supra; Schleg v. Commissioner*, 375 F. 2d 747 (2d Cir. 1967); *Lamont v. Commissioner*, 339 F. 2d 377 (2d Cir. 1964). The standard to be used in applying this rule is:

"A finding is 'clearly erroneous' when although there is evidence to support it, the reviewing court on the entire evidence is left with the definite and firm conviction that a mistake has been committed." *United States v. United States Gypsum Co.*, 333 U. S. 364, 395, 68 S. Ct. 525, 542 (1948).

The record shows, as the Tax Court so found, that:

(1) No kiosks were contemplated by Midtown in the North Mall at the time the agreement between taxpayers and Midtown was entered into. Even if kiosks were contemplated, taxpayers by controlling Midtown could have prevented the erection and rental of kiosks in the North Mall.

(2) The use of the North Mall for non-commercial activities was preferable to obtaining kiosk rentals.

(3) Only one of Midtown's tenants had bargained for a lease provision prohibiting the erecting of kiosks.

(4) The taxpayers payments were disguised capital contributions to Midtown.

The substance of the expense, not its legal form, controls its deductibility under § 162. *Interstate Transit Lines v. Commissioner*, 319 U. S. 590, 63 S. Ct. 1279 (1943); *Deputy v. DuPont*, 308 U. S. 488, 60 S. Ct. 366 (1940); *Lots, Inc. v. Commissioner*, 49 T. C. 540 (1968). Thus, the characterization of the expense by taxpayers as being either for advertising or for rent is not determinative. The payment in question is to be judged in light of all the terms and conditions of the agreement establishing the obligation to pay and all the facts and circumstances existing at the time the agreement was made. The fact that the taxpayer is contractually bound to make the payment does not render it an ordinary expense. *Interstate Transit Lines v. Commissioner, supra; Sneed Distributing Co. v. Commissioner*, 323 F. 2d 480 (5th Cir. 1963); *The Atlantic Monthly Co. v. Commissioner*, 5 T. C. 1024 (1945). Considering the close relationship between taxpayers and Midtown, the payments to prevent the building of the kiosks must be subject to close scrutiny. *Higgins v. Smith*, 308 U. S. 473, 60 S. Ct. 355 (1940); *Darco Realty Corp. v. Commissioner*, 301 F. 2d 190 (2d Cir. 1962); *Ingle Coal Corp. v. Commissioner*, 174 F. 2d 569 (7th Cir. 1949). The identity of interests between the officers, directors and stockholders of taxpayers and of Midtown renders the transaction one of less than at arm's length. *Ray's Clothes v. Commissioner*, 22 T. C. 1332 (1959). The evidence bearing on the transaction must be scrutinized to determine the true character of the agreement and whether it would have been entered into were the taxpayers and Midtown dealing at arm's length. In *Place v. Commissioner*, 17 T. C. 199 (1951), *aff'd*, 199 F. 2d

373 (6th Cir. 1952), *cert. denied*, 345 U. S. 927, 73 S. Ct. 496 (1953), a businessman voluntarily increased his rental payments to his lessor, his wife. The Court disallowed the deduction of the additional rent as a business expense, holding that the increased sum was not paid as rent, that it was paid under the guise of rent. The close relationship between the parties and the lack of arm's length dealing made the increase an attempt to avoid taxes. The test for determining deductibility is whether a hard-headed businessman, under the circumstances, would have incurred the expense. 4A Mertens Law of Federal Income Taxation § 25.09, p. 50. Application of this test amply supports the Tax Court's findings and conclusions with respect to the deductibility of the kiosk payments. No hard-headed businessmen would have incurred this extra, annual expense of $75,000.00. The deductibility of these annual payments is not allowable if the obligation to pay is in essence a camouflaged assignment of income. *Audano v. United States*, 428 F. 2d 251 (5th Cir. 1970). Payments to discharge obligations so created are not ordinary and necessary. *Audano, supra; Van Zandt v. Commissioner*, 341 F. 2d 440 (5th Cir. 1965), *cert. denied*, 382 U. S. 814, 86 S. Ct. 32 (1965). Forman and McCurdy both had substantial tax benefits as a result of treating their respective payments of $75,000.00 per year as deductible expenses, while Midtown received working capital with which to offset its continuing losses.

Taxpayers relied on two cases in support of their contention that the $75,000.00 annual payments by each of them were deductible. Neither *Hamlin Trust v. Commissioner*, 19 T. C. 718 (1953), *aff'd*, 209 F. 2d 761 (10th Cir. 1954), nor *Ullman v. Commissioner*, 29 T. C. 129 (1957), *aff'd*, 264 F. 2d 305 (2d Cir. 1959), relied upon by the taxpayers, is applicable. Both of these cases involved covenants not to

compete, which were reached as a result of arm's length negotiations which clearly distinguish them from the instant case.

We hold that the finding of the Tax Court, that the annual payments by the taxpayers to Midtown were capital contributions—not rent or business expenses, was not clearly erroneous.

We affirm the Tax Court's decision that these annual payments were not deductible as ordinary and necessary business expenses. We reverse the Tax Court decision that the Commissioner was without authority to allocate to the taxpayers interest income on their non-interest bearing loans to Midtown and remand to the Tax Court for such allocation.

Judgment of the Court of Appeals for the Second Circuit

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the tenth day of January one thousand nine hundred and seventy-two.

Present:

Hon. Tom C. Clark,
Associate Justice.

Hon. J. Joseph Smith,
Circuit Judge.

Hon. Joseph C. Zavatt,
District Judge.

B. FORMAN COMPANY, INC.,
McCURDY & COMPANY, INC.,
Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellant.

Appeal from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order

of said The Tax Court of the United States be and it hereby is affirmed in part and reversed in part and that the action be and it hereby is remanded to said Tax Court for further proceedings in accordance with the opinion of this court with costs to be taxed against the petitioners-appellants, B. Forman Co. Inc., and McCurdy & Co. Inc.

A. DANIEL FUSARO,
Clerk.

United States Court of Appeals
Second Circuit
Filed, January 10, 1972
A. Daniel Fusaro, Clerk
Cal. #'s 768-771

A true copy,
/s/ A. Daniel Fusaro,
Clerk.